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Dear Clients and Friends:


Recent events such as the current turmoil in the credit markets and widespread defaults on sub-prime mortgage loans, accompanied by increasing investor focus on the methods used by management to value assets and liabilities, highlight the importance of fair value measurements. FAS 157, the focus of this guide, is a principles-based standard that, with few exceptions, impacts all fair value measurements in a reporting entity’s balance sheet.

In this guide, we describe the key concepts and requirements of FAS 157 and the fair value option, and include specific discussion of the impact of the fair value measurement requirements in significant accounting areas such as investments, impairments, and business combinations. We also address fair value measurements in the context of certain industry-specific matters. The purpose of this guide is to clarify a complex area of accounting by bringing together in one publication all of the relevant PricewaterhouseCoopers guidance on fair value measurements; to provide an overall framework for the application of fair value measurements; to highlight key questions and answers; and to offer our perspectives throughout, based on our analysis of the guidance and experience in applying it.

The FASB is in the process of issuing additional interpretive guidance on FAS 157. We will keep you up to date on new guidance through further communications whenever necessary and useful.

While this guide is intended to clarify the fundamental principles of fair value measurements and to highlight key points that should be considered when determining the fair value of assets and liabilities, it is not a substitute for thorough analysis of the facts and circumstances surrounding specific fair value measurements, nor should it be read in place of the relevant accounting literature. Nonetheless, we trust that you will find in these pages the information and insights you need to work with greater confidence and certainty when applying fair value measurements.

PricewaterhouseCoopers
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Chapter 1: Overview
Chapter 1: Overview

Why is Fair Value Important?

Fair value continues to gain momentum as an important measurement basis in financial reporting. Investors continue to desire more timely and transparent information about how fair value measurements impact the financial statements. In addition, standard setters continue to include fair value measurements in recent accounting standards and guidance. Examples include:

- **The fair value option**: In the past two years, the Financial Accounting Standards Board (FASB or Board) issued three standards that provide reporting entities with the option of reporting certain financial statement items at fair value. FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140* (FAS 155), FASB Statement No. 156, *Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140* (FAS 156), and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115* (FAS 159), issued in February 2006, March 2006, and February 2007, respectively, allow reporting entities to apply a fair value option (FVO) to certain financial instruments and related servicing assets and liabilities. The FASB’s next fair value project is under way and may open the door to recording certain non-financial assets and liabilities at fair value in the future.

- **Increasing requirement to use fair value**: Beginning in 2009, FASB Statement No. 141 (revised 2007), *Business Combinations* (FAS 141(R)), will require that assets and liabilities acquired in a business combination be reported at fair value, with certain limited exceptions. Other standard-setting projects in progress that are exploring the use of fair value include commodity inventory, leases and contingencies.

- **International Financial Reporting Standards (IFRS)**: IFRS already provides a fair value option and the International Accounting Standards Board is considering a fair value measurement standard intended to be aligned with FASB Statement No. 157, *Fair Value Measurements* (FAS 157 or the Standard). As generally accepted accounting principles in the United States (U.S.) move closer to convergence with IFRS, understanding the use of fair value in the international arena also becomes increasingly important.

The increasing requirement to use fair value in financial reporting underscores the importance of providing timely, transparent, and reliable information that is based on a consistent fair value measurement framework.

Why Issue a Standard on Fair Value?

As the use of fair value has evolved, fair value measurement methodologies and disclosure requirements have not been based on a consistent framework. As individual accounting standards have been issued, fair value has been incorporated on a piecemeal basis, using different definitions of fair value and establishing different disclosure requirements. The results have been inconsistent fair value measurement methodologies and financial statement...
disclosures that have not provided the desired level of transparency for financial statement users.

In response to these factors, the FASB issued FAS 157 in September 2006. FAS 157 addresses how reporting entities should measure fair value for measurement or disclosure purposes under generally accepted accounting principles in the United States (GAAP). With limited exceptions, FAS 157 establishes a common definition of fair value to be used throughout GAAP. The FASB believes that FAS 157 will improve consistency and comparability in fair value measurements and will enhance transparency for users of the financial statements.

FAS 157 is effective for fiscal years beginning after November 15, 2007. At its November 14, 2007 meeting, the Board voted to propose a FASB Staff Position (FSP) that would defer the effective date of FAS 157 for one year for nonfinancial assets and nonfinancial liabilities that are recognized and disclosed at fair value in the financial statements on a nonrecurring basis. This action is in response to feedback the Board received about the many implementation challenges related to the application of FAS 157 to those assets and liabilities. The proposed deferral will not change the timing of recognition and disclosure requirements for financial assets and liabilities or for nonfinancial assets and liabilities that are remeasured at fair value at least annually. See further discussion in Chapter 6: Effective Date and Transition.

How Does Fair Value Impact Reporting Entities?

There is a common misconception that FAS 157 impacts only financial services companies, because such reporting entities are large holders of investments, derivatives and other instruments that are measured at fair value. In addition, upon initial review, FAS 157 appears to be composed simply of definitions, or "clarifications" of fair value measurements, with some enhanced disclosure requirements. In fact, FAS 157 does not require any new fair value measurements and some reporting entities may initially question whether the Standard will have any effect on them. However, given the pervasiveness of fair value measurements, the effect of adopting FAS 157 will impact reporting entities in all industries. The significant changes are outlined within this publication and the impacted standards are specifically discussed in Appendix B of this guide.

There are numerous accounting areas that incorporate fair value measurements and that will be affected by the new requirements:
Figure 1-1
Scope of FAS 157

The impact of FAS 157 includes:

- Derivatives and trading activities;
- Investments in trading and available-for-sale securities;
- Business combinations, goodwill, and intangibles;
- Asset retirement obligations;
- Impairments of long-lived assets;
- Exit and disposal activities;
- Pensions and other post retirement benefit plans;
- Guarantees; and
- Long-term debt disclosures.

The fair value options provided by FAS 155, FAS 156, and FAS 159 may also further expand the use of fair value measurements in financial statements. It is important for all reporting entities to understand where fair value is used in their financial statements, to consider how their previous practices are affected by FAS 157, and to determine how they will effectively implement the Standard.

How Does the Standard Change Fair Value Measurements?

The concept of fair value evokes a variety of meanings. FAS 157 defines how fair value should be determined for financial reporting purposes by establishing a fair value framework applicable to all fair value measurements under GAAP (except those measurements specifically exempted; see further discussion in Chapter 2: Scope).

FAS 157 changes existing practices related to measurement of fair value by introducing several new concepts. Reporting entities need to understand these concepts and their interaction, including exit price, the principal (or most advantageous) market, and the fair value hierarchy. Reporting entities will also need to understand valuation theory to ensure that fair value measurements comply with FAS 157. Key changes as a result of FAS 157 include the following:

**Fair Value is Based on the Price to Sell an Asset or Transfer a Liability**

FAS 157, paragraph 7, states that “the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).” In many cases, the exit price and the transaction (or entry) price will be the same at initial recognition; however, in certain cases, the transaction price may not be representative of fair value.
In those cases, a reporting entity may recognize initial gain (or loss) upon applying FAS 157, even if the fair value measurement is based on a valuation model that uses significant unobservable inputs. The initial (or “Day One”) gain or loss is the unrealized gain or loss resulting from the difference between the transaction price and the fair value at initial recognition. This change supersedes the guidance provided by the Emerging Issues Task Force (EITF) in footnote 3 of EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* (EITF 02-3), which prohibited the recognition of Day One gains and losses in cases where fair value was not based on observable market data.

In prior practice, the fair value of liabilities was often based on a settlement price concept, which assumes the liability is extinguished. In contrast, under FAS 157, fair value is based on the amount that would be paid to transfer a liability to another entity with the same credit standing. The transfer concept assumes the liability continues after the hypothetical transaction. The valuation of a liability must incorporate nonperformance risk, which represents the risk that a liability will not be paid. Nonperformance risk includes the impact of a reporting entity’s own credit standing. Credit risk, as with other valuation inputs, should be based on assumptions from the perspective of a market participant.

**Focus on Market Participant Assumptions**

FAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. For certain instruments, management’s intended use of an asset, or planned method of settling a liability, has been an important consideration when measuring fair value. This will no longer be the case. Rather, the fair value of an asset or liability should be determined based on a hypothetical transaction at the measurement date, considered from the perspective of a market participant. For instance, if a market participant would assign value to an asset acquired in a business combination, the fair value of the acquired asset should be determined using the market participant’s assumptions regarding its use, even if the acquiring company does not intend to use the asset.

**PwC Observation:** The change from an entity-specific (internal) focus for some measurements to a market (external) focus for all fair value measurements within the scope of FAS 157 is a significant change from previous practice. Reporting entities that currently use entity-specific methods and assumptions to measure fair value, without considering information available from market participants about risks and other relevant factors, may need to change their practices to comply with FAS 157’s objective of measuring fair value by using market participant assumptions.

**The Highest and Best Use Provides the Basis for Valuation of an Asset**

The fair value of an asset is based on the use of the asset by market participants that would maximize its value. The highest and best use of an asset must be determined from the perspective of a market participant, even if the reporting entity intends a different use for the asset. In determining the
highest and best use, the reporting entity must consider whether a market participant would maximize the fair value of the asset on its own (in-exchange) or in use in combination with a group of other assets (in-use). The highest and best use determines the valuation premise and will interact with the determination of potential market participants and markets. Highest and best use incorporates a best price notion and may result in a change from historical reporting, which may have incorporated conservatism in the valuation of assets and liabilities. The interaction between the valuation premise and the principal or most advantageous market is an iterative process.

Importance of Determining the Market

The Standard introduces the concepts of principal and most advantageous markets. A principal market is that market where the reporting entity regularly transacts with the highest volumes and level of activity. The principal market must be available to and accessible by the reporting entity. If there is a principal market, fair value must be determined using prices in that market. If there is no principal market, fair value is based on the price in the most advantageous market (the market which maximizes the amount that would be received for an asset or minimizes the amount that would be paid to transfer a liability).

The determination of the most advantageous market is an iterative process; the reporting entity may have to consider multiple potential markets and the appropriate valuation premise(s) in each market. Once the potential markets are identified, the reporting entity will value the asset in each market in order to determine which one is the most advantageous. If there are no potential or accessible markets, the reporting entity will need to hypothecate a market based on assumptions of potential market participants.

In applying the fair value framework, the determination of highest and best use and development of the fair value measurement are based on market participant assumptions. However, the determination of the principal or most advantageous market is determined from the perspective of the reporting entity, based on its business model and market access.

Incorporation of Standard Valuation Techniques

FAS 157 requires consideration of three broad valuation techniques: the market approach, the income approach, and the cost approach. While the approaches are not new, FAS 157 requires that entities determine the most appropriate valuation technique(s) to use, given what is being measured and the availability of sufficient data. In some cases one valuation technique may be sufficient; in other cases it may be appropriate to incorporate multiple techniques, depending on the specific fact pattern.

The Standard requires that a reporting entity consider the risk inherent in a particular valuation technique (such as an option pricing model) and/or the risk inherent in the inputs to the valuation technique. Accordingly, a valuation technique should include an adjustment for risk if market participants would include such an adjustment in pricing a specific asset or liability.
Introduction of the Fair Value Hierarchy

A significant new concept introduced by FAS 157 is the fair value hierarchy, which prioritizes the inputs into valuation techniques used to measure fair value. A three-level hierarchy was established to provide greater transparency and comparability among reporting entities. FAS 157 prioritizes observable data from active markets, placing measurements using those inputs in the highest level of the fair value hierarchy (Level 1). The lowest level in the hierarchy (Level 3) includes inputs that are unobservable (which may include entity-specific assumptions). In response to some constituents’ concerns about the reliability of fair value measurements based on unobservable data, additional disclosure is required for Level 3 measurements.

Other Changes to Fair Value Measurement Practices

FAS 157 also changes current fair value measurement practices as follows:

- **Elimination of blockage factors**: A blockage factor is a discount applied to the value of a security to reflect the impact on the quoted price of selling a large block of the security at one time. FAS 157 does not allow application of a blockage factor in valuing financial instruments in active markets; the fair value of such securities will be equal to the quoted price multiplied by the quantity, without any adjustment to reflect a blockage factor. This change applies to all entities, including broker dealers and investment companies that may have previously applied industry-specific guidance that permitted application of blockage factors.

- **Change in valuation of restricted securities**: FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115), applies to certain marketable equity securities and debt securities. Previously, FAS 115 did not permit reporting entities to adjust valuations to reflect the impact of restrictions of one year or less on the sale of a security. (Equity securities for which sale is restricted for a period of more than one year are outside the scope of FAS 115.) In contrast, in measuring the fair value of a restricted security, FAS 157 requires a reporting entity to value all securities reported at fair value based on market participant assumptions. Thus, if a market participant would reduce the quoted price of an identical unrestricted security due to a restriction on sale, that reduction should be incorporated in the fair value measurement under FAS 157.

  Consideration of the restriction is required only if it is an attribute of the security and does not arise from an agreement or condition that is not an attribute of the security itself.

- **Change in transaction costs**: In accordance with FAS 157, transaction costs are not an attribute of the asset or liability. Therefore, absent specific guidance under other GAAP applicable to a particular asset or liability (e.g., pension investments), transaction costs shall not be included in the measurement of fair value.

  However, transaction costs are included in determining the most advantageous market. In making that determination, a reporting entity will calculate the net amount that would be received from the sale of an asset or paid to transfer a liability. The price received or amount paid is adjusted by
the transaction costs. The treatment of transaction costs is illustrated in FAS 157, Example 6 (paragraph A23).

Expanded Disclosure Requirements

FAS 157 significantly expands and standardizes disclosure requirements related to fair value measurements, with the objective of providing (1) information to users about how and where fair value is used in the financial statements, (2) the methods used to measure fair value, and (3) a perspective about the reliability of the inputs used to determine those fair value measurements.

The Standard differentiates between disclosures required for assets and liabilities that are measured at fair value on a recurring basis and nonrecurring fair value measurements. Required disclosures include information about fair value measurements impacting the financial statements, allocation of fair value measurements among the levels within the fair value hierarchy, and additional disclosures for measurements using significant unobservable inputs. In addition, reporting entities are required to disclose the valuation technique(s) used to measure fair value and any changes in those technique(s) during the period on an annual basis.

Figure 1-2
FAS 157 – Summary of Key Changes

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition of fair value</strong></td>
<td>Focus on ENTRY price (some measurements). How much would be paid to acquire an asset or to settle a liability?</td>
</tr>
<tr>
<td><strong>Assumptions</strong></td>
<td>Entity-specific assumptions (some measurements)</td>
</tr>
<tr>
<td><strong>Measuring fair value</strong></td>
<td>Inconsistent guidance throughout GAAP standards</td>
</tr>
<tr>
<td><strong>Day One gains and losses</strong></td>
<td>EITF 02-3 disallowed Day One gains and losses if based on unobservable data</td>
</tr>
<tr>
<td><strong>Disclosures</strong></td>
<td>Statement-specific disclosure of fair value with minimal transparency of approach / procedures</td>
</tr>
</tbody>
</table>
What is the Impact of the Fair Value Option?

The issuance of FAS 155, FAS 156, and FAS 159 provides reporting entities with the opportunity to elect to report certain financial instruments, selected hybrid financial instruments, and separately recognized servicing assets and servicing liabilities at fair value. The fair value option provides reporting entities with the opportunity to mitigate potential mismatches that currently occur in financial reporting (e.g., an entity could elect the fair value option and report both the underlying debt and an interest rate swap at fair value, thus avoiding the application of hedge accounting). However, this election may reduce comparability both among reporting entities and within a reporting entity’s financial statements. The use of the fair value option also further increases the fair value measurements included in the financial statements.
Chapter 2:
Scope
Chapter 2: Scope

2.1 Scope

FAS 157 applies under all other accounting pronouncements that require or permit fair value measurements, with limited exceptions as specified in the Standard. In addition, it is not applicable to measurements that are similar to fair value but that are not intended to measure fair value. These scope exclusions are further described below.

Significant accounting pronouncements affected by the Standard include the following:

**Figure 2-1**

**Pronouncements in Scope**

<table>
<thead>
<tr>
<th>Non-monetary transactions (APB 29, FAS 153)</th>
<th>Debt and equity investments (FAS 115)</th>
<th>Long lived assets (FAS 144)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Troubled debt restructurings (FAS 15)</td>
<td>Derivatives (FAS 133)</td>
<td>Exit and disposal costs (FAS 146)</td>
</tr>
<tr>
<td>Employee benefits (FAS 35, FAS 87, FAS 106)</td>
<td>Transfers of assets and servicing (FAS 140, FAS 156)</td>
<td>Liabilities and equity (FAS 150)</td>
</tr>
<tr>
<td>Insurance (FAS 60)</td>
<td>Business combinations (FAS 141, FAS 141(R))</td>
<td>Hybrid financial instruments (FAS 155)</td>
</tr>
<tr>
<td>Mortgage banking (FAS 65)</td>
<td>Goodwill and intangibles (FAS 142)</td>
<td>Fair value option (FAS 159)</td>
</tr>
<tr>
<td>Financial instruments (FAS 107)</td>
<td>Asset retirement obligations (FAS 143)</td>
<td>Guarantees (FIN 45)</td>
</tr>
</tbody>
</table>

FAS 157, Appendix D, lists all Accounting Principles Board (APB) and FASB pronouncements that refer to fair value, and it specifically highlights those standards that are amended by FAS 157.

Issues related to the application of fair value measurements within specific accounting pronouncements are discussed in Chapter 8: Application – Potential Recurring Measurements and Chapter 9: Application – Nonrecurring Measurements. In addition, Appendix B of this guide summarizes the impact of FAS 157 on significant pronouncements affected by the Standard.
2.1.1 Scope Exceptions

FAS 157, paragraph 2, states:

This Statement applies under other accounting pronouncements that require or permit fair value measurements, except as follows:

a. This Statement does not apply under accounting pronouncements that address share-based payment transactions: FASB Statement No. 123 (revised 2004), Share-Based Payment, and its related interpretive accounting pronouncements that address share-based payment transactions.

b. This Statement does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this Statement. (footnotes omitted)

2.1.1.1 Share Based Payments

FAS 157 does not apply to share-based payments under FASB Statement No. 123 (revised 2004), Share-Based Payment (FAS 123(R)). In addition to excluding FAS 123(R), the FAS 157 exception also extends to FAS 123(R)’s related interpretive guidance including EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services (EITF 96-18), and EITF Issue No. 00-8, Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services (EITF 00-8). EITF 96-18 and EITF 00-8 apply to share-based payments granted to non-employees.

2.1.1.2 Practicability Exceptions

FAS 157 preserves practicability exceptions to fair value measurements that are provided by other accounting pronouncements. Footnote 2 and paragraph C21 of FAS 157 describe those exceptions, including the following:

- Measurements that use a transaction price instead of an exit price. For example, FAS 157 does not change the guidance requiring the use of a transaction price (an entry price) to measure fair value at initial recognition of guarantees under FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others – an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34 (FIN 45), or permitting the use of the transaction price for financial assets and liabilities under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – a replacement of FASB Statement No. 125 (FAS 140).

- Certain measurements for which determining fair value is not practicable or reasonably determinable, such as the exceptions provided by FASB Statements No. 107, Disclosures about Fair Value of Financial Instruments (FAS 107), No. 143, Accounting for Asset Retirement Obligations (FAS 143), and No. 153, Exchanges of Nonmonetary Assets – an amendment of APB Opinion No. 29 (FAS 153).
• Fair value measurements that are not reliable, such as the exception provided by FASB Statement No. 116, Accounting for Contributions Received and Contributions Made (FAS 116).

• Certain measurement methods other than fair value used for assets and liabilities acquired in a business combination, as described in paragraph 37 of FASB Statement No. 141, Business Combinations (FAS 141).

FAS 157, paragraph C22, discusses the Board’s decision to retain the practicability exceptions. The Board acknowledged that this results in some inconsistency in practice; however, it concluded that some of the exceptions are being resolved in other projects. For example, upon its effective date, FAS 141(R) will eliminate most of the practicability exceptions provided under FAS 141 (see further discussion in Section 9.1, "Business Combinations"). In addition, the Board indicated that the other practicability exceptions raised questions about what should be measured at fair value and that such questions are beyond the scope of FAS 157.

PwC Observation: While FAS 157 retains existing practicability exceptions, reporting entities should carefully consider whether the use of the exceptions is appropriate, particularly in cases where the entity is asserting that a fair value measurement is not readily determinable or reliable. While FAS 157 places an emphasis on observable, market-driven data for determining fair value, the Standard specifically recognizes that some fair value measurements may incorporate unobservable data. FAS 157 requires robust, transparent disclosure to compensate for the potential lack of reliability of such measurements. Refer to Section 4.4, "Inputs to Valuation Techniques" and Section 4.5, "Fair Value Hierarchy," for further discussion.

A more detailed description of the practicability exceptions is also included in Appendix B of this guide.

2.1.1.3 Lease Accounting

As originally issued, the guidance in FAS 157 applied to fair value measurements required by FASB Statement No. 13, Accounting for Leases (FAS 13). However, subsequent to the issuance of FAS 157, concerns were raised about the interaction of the fair value measurement objective of FAS 13 with the fair value measurement objective of FAS 157. Specific concerns centered on the initial fair value measurements used for determining lease classification and how to apply the FAS 157 fair value measurement objective to estimated residual values.

In response to these concerns, in November 2007 the FASB issued proposed FSP FAS 157-a, Application of FASB Statement No. 157 to FASB Statement No. 13 and Its Related Interpretive Accounting Pronouncements That Address Leasing Transactions (FSP FAS 157-a). FSP FAS 157-a proposes to amend FAS 157 to exclude FAS 13 and related interpretive guidance from its scope. Paragraph 6 of the proposed FSP states, in part:
… the Board believes that the lease accounting provisions and the longstanding valuation practices common within the leasing industry should not be changed by Statement 157 without a comprehensive reconsideration of the accounting for lease transactions.

**PwC Observation:** While the proposed FSP is subject to a 30-day comment period and final approval by the FASB, we expect that the Board will approve the lease exception consistent with the discussion above. Reporting entities should continue to monitor the activities of the FASB for the final outcome of this issue.

### 2.1.1.4 Impact on Measurements Similar to Fair Value

As discussed in FAS 157, paragraph 3, the Standard also does not apply to accounting pronouncements that use measurements that are similar to fair value, but that are not intended to measure fair value. Those include:

- Revenue-recognition transactions that are measured based on vendor-specific objective evidence (VSOE) of fair value, including measurements in accordance with the guidance provided by American Institute of Certified Public Accountants (AICPA) Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2); AICPA Statement of Position 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*; EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21); and EITF Issue No. 00-3, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity’s Hardware*; and

- Lower of cost or market measurements in accordance with Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (ARB 43), Chapter 4, “Inventory Pricing.”

The exclusions described in the Standard appear to be straightforward; however, the accounting guidance in excluded areas extends to additional accounting pronouncements not specifically referenced in the Standard. In addition, other terminology in the accounting literature exists that is similar to that referenced in FAS 157. As a result, certain questions arise with respect to the scope of FAS 157’s exceptions and exclusions as follows:

**Question 2-1: Is inventory subject to the requirements of FAS 157 when measuring impairment or reserves?**

**PwC Interpretive Response**

Paragraph 3 of FAS 157 scopes out measurements that are similar to fair value but that are not intended to measure fair value. The scope exception specifically identifies inventory pricing pursuant to ARB 43 as being outside the scope of FAS 157.

ARB 43 requires that inventory be recorded at cost, unless cost falls below market, at which time the inventory must be written down to market. The accounting requirement is referred to as reporting on the basis of lower of cost or market. ARB 43, Chapter 4, Statement 6, defines market as current
replacement cost not to exceed net realizable value and not to be less than net realizable value less a normal profit margin.

By scoping inventory pricing out of FAS 157, the Board retained the accounting framework set out in ARB 43. The primary difference between fair value under FAS 157 and market measurements under ARB 43 is the accounting for the normal profit margin. By retaining the ARB 43 definition of market, market measurements of inventory will continue to include an amount that provides for a normal profit margin at the time of sale, rather than an exit value at the measurement date as would be required by FAS 157.

**Question 2-2: Does FAS 157 apply to fair value amounts under EITF 00-21 and SAB 104?**

**PwC Interpretive Response**

FAS 157, paragraph 3, states that it “does not apply under accounting pronouncements that require or permit measurements that are similar to fair value but that are not intended to measure fair value.” This exclusion includes measurements based on vendor-specific objective evidence of fair value used under EITF 00-21 and SOP 97-2. There are other similar measurements under EITF 00-21 and U.S. Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition* (SAB 104). For example, third-party vendor objective evidence of fair value is a market-based measurement and could be used in the absence of VSOE to support revenue recognition under an arrangement with multiple deliverables. Such evidence could be in the form of a reporting entity’s or its competitor’s prices of largely interchangeable products or services in sales to similarly situated customers.

FAS 157, paragraph C23 states, in part:

… vendor-specific objective evidence of fair value refers to the price for a deliverable established by the reporting entity. … Conceptually, vendor-specific objective evidence of fair value is a measurement determined based on a transaction price (an entry price) that is different from a fair value measurement (an exit price), whether considered from the perspective of the reporting entity or a third-party vendor (as a practical expedient). (emphasis added)

Under EITF 00-21 and SAB 104, the fair value measurement objective of determining the transaction price (entry price) for a portion of a multiple element arrangement is the same regardless of whether the measurement is based on VSOE of fair value or based on a third-party vendor (as a practical expedient). This may result in a measurement that is substantially different from a measurement of fair value under FAS 157. As a result, we believe the provisions of FAS 157 do not change how fair values are determined for individual units of accounting for multiple-element revenue contracts, whether VSOE or other vendor objective evidence of fair value is used in these circumstances.
Chapter 3:
Framework for Application of FAS 157
Chapter 3: Framework for Application of FAS 157

FAS 157 introduces an overall framework for purposes of measuring fair value. In accordance with this framework, a reporting entity should apply a structured approach in determining all fair value measurements that are within the scope of the statement. Key elements of the approach are depicted in the flowchart below:
We further discuss the concepts underlying FAS 157 in Chapter 4: Concepts and provide practical application considerations in Chapter 8: Application – Potential Recurring Measurements, Chapter 9: Application – Nonrecurring Measurements, and Chapter 10: Industry Specific Guidance. In addition, to assist in applying this framework, we provide an overview of the five-step application methodology as follows:

**Step One: Determine Unit of Account**

The reporting entity must determine the unit of account (i.e., what is being measured). As further discussed in FAS 157, paragraph 6, the unit of account is determined based on other applicable generally accepted accounting principles. Therefore, for example, the unit of account for a derivative generally is the entire contract and the unit of account for the first step of a goodwill impairment analysis is the reporting unit. See further discussion of key concepts regarding this area in Section 4.1.1, “Unit of Account.”

**Step Two: Determine Potential Markets Based on the Highest and Best Use**

After determining the unit of account, the reporting entity must assess the highest and best use for the asset, based on the perspective of market participants. In accordance with FAS 157, paragraph 12, the fair value of an asset is based on the use of the asset by market participants that would maximize its value. The highest and best use for an asset must be determined based on the perspective of market participants, even if the reporting entity intends a different use.

Consideration of the highest and best use for an asset is an integral part of the identification of potential markets where the asset can be sold and establishes the valuation premise. The valuation premise may be either in-use or in-exchange.

Liabilities are valued based on the transfer of the liability to a market participant on the measurement date. However, reporting entities must still consider potential markets for the transfer of the liability. See further discussion of the determination of the highest and best use in Section 4.1.5, “Valuation of Assets (Valuation Premise.”

**Step Three: Determine Markets for Basis of Valuation**

Once a reporting entity has considered potential markets, market participants, and the valuation premise, it must assess whether it has access to any potential markets. If access is available, a reporting entity must consider the following:

- Is there a principal market for the asset or liability? In accordance with FAS 157, paragraph 8, the principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. If there is a principal market, the fair value measurement represents the price in that market, even if the price in another market is potentially more advantageous.
Furthermore, based on this guidance, if the reporting entity does have a principal market, it will be able to expedite steps two and three. The reporting entity cannot incorporate potentially more advantageous markets in its fair value measurements when it has a principal market.

- What is the most advantageous market? If the reporting entity does not have a principal market, it should determine the most advantageous market for sale of the asset or transfer of the liability. As part of this determination, a reporting entity may need to consider more than one potential market. In each potential market, the entity should evaluate whether the appropriate valuation premise is in-use or in-exchange. In some cases, a reporting entity will need to determine the value in multiple markets and may need to consider both valuation premises in one or more markets, in order to determine the highest fair value.

The market determination should incorporate the appropriate valuation technique(s), as further described in step four below. The reporting entity will determine the most advantageous market using valuation technique(s) consistent with market participant assumptions in each of the potential markets. The market that results in the highest value for the asset or the lowest amount that would be paid to transfer the liability (after transaction costs) will represent the most advantageous market.

In the application of the framework, it is important to note that the determination of highest and best use and development of the fair value measurement are based on market participant assumptions. However, the determination of the principal or most advantageous market is determined from the perspective of the reporting entity itself based on its business model and market access.

If there are no potential markets for the asset or liability, the reporting entity must develop a hypothetical market based on the assumptions of potential market participants. See further discussion in Section 4.1.3, “Principal or Most Advantageous Market,” and Section 4.1.4, “Market Participants.”

**Step Four: Apply the Appropriate Valuation Technique(s)**

The Standard outlines three potential valuation techniques: the market approach, the income approach and the cost approach. It requires that the reporting entity consider and apply each valuation technique that is appropriate in the circumstances and for which market participant pricing inputs can be obtained without undue cost and effort. See further discussion in Section 4.3, “Valuation Techniques,” and Section 4.4, “Inputs to Valuation Techniques.”

**Step Five: Determine Fair Value**

The outcome of the market determination and the application of valuation technique(s) will be a fair value measurement. To the extent that the valuation was applied to an asset that was valued in-use, the total calculated value must be allocated to each unit of account in the asset grouping based on the specific facts and circumstances.
Chapter 4:
Concepts
Chapter 4:  Concepts

This chapter discusses the key concepts introduced by FAS 157 and addresses certain specific issues associated with implementation. To assist in application, we have also summarized the FAS 157 concepts and overall fair value framework in a diagram and supplemental discussion in Chapter 3: Framework for Application of FAS 157.

4.1 Definition of Fair Value

FAS 157, paragraph 5, defines fair value:

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

This definition of fair value retains the exchange-price notion contained (either explicitly or implicitly) in many earlier GAAP definitions of fair value. However, in accordance with FAS 157, fair value is based on the exit price – the price that would be received to sell an asset or paid to transfer a liability, not the transaction price or entry price – the price that was paid for the asset or that was received to assume the liability. Conceptually, entry and exit prices are different. The exit price concept is based on current expectations about the sale or transfer price from the perspective of market participants. Under FAS 157, a fair value measurement should reflect all of the assumptions that market participants would use in pricing an asset or liability.

4.1.1 Unit of Account

As described in FAS 157, paragraph 6, fair value is measured for a particular asset or liability and, thus, should incorporate its specific characteristics, such as condition, location, and restrictions, if any, on sale or use as of the measurement date. In some cases, the fair value measurement will be applied to a stand-alone asset or liability (e.g., a debt security or derivative instrument) or a group of related assets and/or liabilities (such as a reporting unit or a business). The determination of how the fair value measurement applies to an asset or a liability depends on the unit of account.

The unit of account is determined based on the level at which the asset or liability is aggregated or disaggregated in accordance with GAAP applicable to the particular asset or liability being measured, with one exception. FAS 157, paragraph 27, specifically precludes application of a blockage factor to a single financial instrument traded in an active market. See further discussion of this restriction in Section 4.5.1, “Level 1 Inputs.”

4.1.2 Price

Fair value is the price that would be received (asset) or paid (liability) in “an orderly transaction between market participants at the measurement date.” FAS 157, paragraph 7, in part, further describes an orderly transaction as follows:
An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability.

This definition emphasizes the use of market participant assumptions in the determination of fair value. In addition, the concept of an orderly transaction precludes a distress sale or a forced liquidation by the reporting entity in the determination of fair value. For example, assume the normal lead time for sale of an operating asset is approximately three months, to allow for marketing and sufficient due diligence by market participants. However, if a company needed to raise cash quickly due to a liquidity crisis, it may agree to a distress sale of certain operating assets at lower-than-market prices. These transactions would not be representative of the fair value for the related assets. In a forced liquidation, the transaction price may not equal the fair value of the asset or liability at initial recognition (see further discussion in Section 4.2, “Fair Value at Initial Recognition” below.

4.1.2.1 Impact of Market Issues

As a result of the recent increase in defaults by sub-prime mortgage borrowers and the resulting turmoil in the credit markets, some reporting entities have questioned whether the market prices for financial assets backed by sub-prime mortgages are consistent with fair value under FAS 157. Specifically, a question arises as to whether those market prices represent a forced liquidation or distressed sale and, therefore, are not indicative of fair value.

In September 2007, the AICPA Center for Audit Quality (CAQ) released a whitepaper that addressed market liquidity. The CAQ stated that if orderly transactions are occurring between market participants in a manner that is normal and customary for those assets, then those transactions are not “forced” sales. It further stated that it is not appropriate to assume that all transactions in a relatively illiquid market are forced or distressed.

**PwC Observation:** We support the CAQ view and believe that current observable market transactions provide an indication of fair value and market conditions. For certain securities for which there are no market transactions or observable trading information, reporting entities will have to rely on other market inputs (e.g., credit spreads on similar securities or ratings), apply judgment, and make informed estimates.

4.1.3 Principal or Most Advantageous Market

FAS 157, paragraph 8, discusses the concepts of principal market and most advantageous market. In accordance with this guidance:

- The principal market is the market in which the reporting entity transacts with the greatest volume and level of activity for the asset or liability.
• The most advantageous market is the market in which the reporting entity would receive the highest selling price for an asset, or pay the lowest price to transfer the liability, after considering transaction costs.

The determination of the principal or most advantageous market is an important step in applying the FAS 157 framework. During its deliberations on FAS 157, the Board considered what market should be used to determine fair value. The Board acknowledged that (1) items can be exchanged in different markets, (2) different markets may have different prices at which items are exchanged, (3) different markets may have different participants, and (4) not all entities have access to the same markets. In recognition of the diversity of both markets and market participants, the Board provided guidance under a principal (or most advantageous) market concept to identify the market that reporting entities should look to in determining the exit price.

4.1.3.1 Principal Market

In determining its exit market, a reporting entity should look first to the market that represents a majority of its volumes (i.e., the principal market). In many cases, a reporting entity may regularly buy and sell a particular asset and may have clearly identified exit markets. For example, a company engaged in trading natural gas may buy and sell financial gas commodity contracts on the New York Mercantile Exchange (NYMEX) and in the bilateral markets. In determining the principal market, the company would need to evaluate the level of activity in the two different markets. The reporting entity's principal market will be the market where it has the greatest activity, even if the prices in the other market are more advantageous. The fair value measurement will be based on the prices in the reporting entity's principal market.

If there is a principal market for the asset or liability, FAS 157 states that fair value should be based on the price in that market, even if the price in a different market is potentially more advantageous at the measurement date. As further discussed in FAS 157, paragraph C28, the Board concluded that in most cases, the principal market would represent the most advantageous market and did not want to require a reporting entity to continuously evaluate multiple prices for an asset or a liability in order to determine the most advantageous market. The price in the most advantageous market should be used only when the reporting entity does not have a principal market for the asset or liability.

4.1.3.2 Most Advantageous Market

If the reporting entity does not have a principal market for a particular asset or liability, it should evaluate all potential markets in which it could reasonably expect to sell the asset or transfer the liability. The identification of potential markets will be based on the "highest and best use" of the asset as determined from the perspective of market participants. As part of this determination, a reporting entity may need to consider more than one potential market. In each potential market, the reporting entity should evaluate the appropriate valuation premise (see further discussion in Section 4.1.5, "Valuation of Assets (Valuation Premise") below. In order to determine the highest fair value of an asset, a reporting entity may need to determine the value in multiple markets and may need to consider both valuation premises in one or more markets.
4.1.3.3 No Potential Markets

There may be situations where there is no known market for an asset or liability or a reporting entity may not have access to any markets. For example, there may be no specific market for the sale of a reporting unit or long-lived asset. In such cases, the reporting entity should identify potential market participants (e.g., strategic or financial buyers). The reporting entity will develop a hypothetical market based on the expected assumptions of those market participants.

If a reporting entity cannot access a particular market, that market should not be considered as a principal or most advantageous market; however, if the reporting entity does not have access to any markets, inaccessible known markets may be considered in developing the inputs that would be used in a hypothetical market.

4.1.3.4 Market Determination – Other Considerations

The principal or most advantageous market is determined from the perspective of the reporting entity, which allows for differences among entities with different activities. For example, FAS 157, paragraph A27, describes a securities dealer that enters into an interest rate swap with a retail customer. From the perspective of the securities dealer, the principal market for the swap is the inter-dealer market; however, the principal market for the retail customer is the retail market.

In addition, different operating units within a reporting entity may transact in different markets and each separate unit must individually consider the principal or most advantageous market. Therefore, the same reporting entity could have different fair value measurements for identical or similar assets or liabilities, depending on the operating units holding the assets or liabilities and differences in the markets in which they transact. For example, a reporting entity with operating units in Asia, Europe and the U.S. may each hold investments in the same debt and equity securities. The fair value measurements reported by the operating units may differ at times due to differences in the markets which they transact and their determination of principal and most advantageous markets. FAS 157 requires that each reporting unit consider the facts and circumstances appropriate to its valuation of the asset or liability being valued and follow the framework of the Standard independent of other reporting units that may be valuing an identical or similar asset or liability.

Although the appropriate market is determined from the perspective of the reporting entity, fair values within those markets are determined based on the assumptions of market participants. Once the reporting entity has determined potential markets, it should value the asset or liability in each of those markets, considering transaction costs, to identify the most advantageous market. See further discussion of the concept of highest and best use and related considerations in Section 4.1.5, “Valuation of Assets (Valuation Premise).”
4.1.3.5 Transaction and Transportation Costs

FAS 157, paragraph 9, in part, addresses the impact of transaction costs on fair value as follows:

The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. (footnotes omitted)

Transaction costs should be accounted for in accordance with the provisions of other accounting pronouncements. While transaction costs are generally not included in the fair value of the asset or liability under FAS 157, these amounts are included when assessing the net transaction proceeds in the most advantageous market, as described above and in Example 4-1 below. In addition, there are instances in GAAP where the required treatment of transaction costs is different from the approach of FAS 157 (see specific discussion of considerations for benefit plans in Section 8.6, “Pensions and Postemployment Benefit Obligations,” and for investment companies in Question 10-3).

Transportation Costs

If location is a characteristic of the asset or liability being measured (e.g., in the case of a physical commodity), the fair value measurement should incorporate transportation costs. The cost of transporting a physical asset from its current location to the market should be considered in the computation of fair value that is based on the price in that market. For example, assume a company intends to sell corn by using a corn futures contract on the Chicago Board of Trade (CBOT). The contract calls for physical delivery at the Chicago Switching Yard; therefore, because location is an attribute of the contract, the company should deduct the cost of physically transporting the corn to the sale location in the calculation of fair value.

4.1.3.6 Market Determination – Examples

The following examples illustrate the framework for identifying the principal or most advantageous market:

Example 4-1

Market Identification

Company A has identified an impairment of certain equipment. As part of assessing the amount of the impairment, the company must assess the fair value of the equipment for purposes of determining the amount of the impairment loss.

continued
Company A has access to sell identical equipment in one of three markets: the retail, wholesale or auction markets. None of the three markets represents Company A’s principal market because the company does not regularly transact in equipment sales. In the absence of a principal market, the fair value of the equipment should be based on the most advantageous market. The most advantageous market is the market from which Company A would receive the highest selling price for the equipment after considering transaction costs. Company A considers the net proceeds from sales in each market as follows:

<table>
<thead>
<tr>
<th>Market</th>
<th>Equipment Price</th>
<th>Transportation Costs</th>
<th>Fair Value</th>
<th>Transaction Costs</th>
<th>Net Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Market</td>
<td>$10,000</td>
<td>(200)</td>
<td>$9,800</td>
<td>(500)</td>
<td>$9,300</td>
</tr>
<tr>
<td>Wholesale Market</td>
<td>$9,700</td>
<td>(300)</td>
<td>$9,400</td>
<td>-</td>
<td>$9,400</td>
</tr>
<tr>
<td>Auction Market</td>
<td>$9,500</td>
<td>(150)</td>
<td>$9,350</td>
<td>(200)</td>
<td>$9,150</td>
</tr>
</tbody>
</table>

After consideration of the transaction costs, the net proceeds are greater in the wholesale market than in the retail and auction markets. Therefore, the fair value from Company A’s perspective is derived from the wholesale market, which yields net proceeds of $9,400.

However, the result may differ based on the amount of transaction costs. Consider the following example:

<table>
<thead>
<tr>
<th>Market</th>
<th>Equipment Price</th>
<th>Transportation Costs</th>
<th>Fair Value</th>
<th>Transaction Costs</th>
<th>Net Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Market</td>
<td>$10,000</td>
<td>(200)</td>
<td>$9,800</td>
<td>(300)</td>
<td>$9,500</td>
</tr>
<tr>
<td>Wholesale Market</td>
<td>$9,700</td>
<td>(300)</td>
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<td>-</td>
<td>$9,400</td>
</tr>
<tr>
<td>Auction Market</td>
<td>$9,500</td>
<td>(150)</td>
<td>$9,350</td>
<td>(200)</td>
<td>$9,150</td>
</tr>
</tbody>
</table>

In this case, the highest and best use of the asset is derived from the retail market, which yields net proceeds of $9,500, thus the fair value would be $9,800.

**Example 4-2**

**Determination of Most Advantageous Market**

In some cases, there are multiple markets for the same asset or liability. For example, when cars are returned to car leasing companies at the expiration of the lease contract, the leasing company generally can sell the car in multiple markets: (1) the lessee may purchase the car; (2) the lessor may sell the car at an auto auction; (3) the lessor may sell the car to another dealer; or (4) the lessor may sell the car at its own used car lot. Car leasing companies dispose of returned cars differently, given the varying cost structures and profit margins.
associated with each transaction; hence it is difficult to identify a single principal market.

In determining the principal or most advantageous market, we would expect the leasing company to first determine if there is a market in which a majority of its volumes are sold (i.e., is there a principal market?). Absent a principal market, we would expect the leasing company to evaluate markets in which the asset could reasonably expect to be sold and to select the market that returns the highest net proceeds for that type of asset.

4.1.4 Market Participants

FAS 157 emphasizes that a fair value measurement should be based on the assumptions of market participants (i.e., it is not an entity-specific measurement). Market participants are buyers and sellers in the principal (or the most advantageous) market for the asset or liability. FAS 157, paragraph 10, in part, defines market participants as follows:

a. Independent of the reporting entity; that is, they are not related parties

b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. Able to transact for the asset or liability

d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so. (footnote omitted)

The term “related parties” is used consistent with its use in FASB Statement No. 57, Related Party Disclosures.

In identifying potential market participants, FAS 157, paragraph 11 states that reporting entities should consider “factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would transact in that market.” The reporting entity is not required to identify specific market participants but instead to develop a profile of potential market participants.

The determination of potential market participants is a critical step in the overall determination of fair value due to the emphasis on the use of market participant assumptions. In some cases, the identification of market participants may be straightforward as there may be general knowledge of the types of entities that transact in a particular market. However, in certain other cases, a reporting entity may need to make assumptions about the type of market participant that may be interested in a particular asset or liability.

The determination of the appropriate market and market participants may have a significant affect on the fair value measurement. Key issues in making these determinations include the following:
Question 4-1: How should a reporting entity determine a market when there is no apparent exit market for an asset or liability?

PwC Interpretive Response
If there are no apparent exit markets, a reporting entity should determine the characteristics of a market participant to which it would hypothetically sell the asset if it had an opportunity to do so. Once the market participant characteristics have been determined, the reporting entity would identify the assumptions that market participants would use to price the asset. The reporting entity should construct a hypothetical market for the asset based on its own assumptions about what market participants would consider in negotiating a sale of the asset or transfer of the liability.

Key considerations in developing market participant assumptions may include the specific location, condition, and other characteristics of the asset or liability (e.g., assumed growth rates, whether certain synergies are available to all market participants, and risk premium assumptions).

For example, there may be no apparent exit market for customer relationship intangible assets. In this case, a company may consider whether there are strategic buyers in the marketplace that would benefit from the customer relationship(s) that are being valued. Most companies seek to build up their customer base as they grow their businesses, so the company can look to potential participants in its industry that may be seeking additional growth and from there determine a hypothetical group of market participants.

See also additional guidance on determining market participants in Question 9-1.

Question 4-2: How should a reporting entity assess multiple market participants and multiple uses for assets when determining fair value?

PwC Interpretive Response
In some cases, a reporting entity may have more than one potential exit market, multiple potential uses and many market participants in each exit market. FAS 157, paragraph C28, in part, addresses multiple market scenarios as follows:

The Board agreed that its intent was not to require that entities continuously search across all possible markets in which transactions for the related asset or liability can be observed for the most advantageous price for the asset or liability.

FAS 157, paragraph C86, in part, further states:

In this Statement, the Board clarified that the reporting entity need not undertake all possible efforts to obtain information about the assumptions that market participants would use in pricing the asset or liability or otherwise establish the absence of contrary data indicating that market participants would use different assumptions.

Consistent with this guidance, a reporting entity should use information reasonably available to it when developing its profile of market participants.
Similar to the approach for determining market participants, a reporting entity should consider realistic scenarios as to how identified market participants would use the asset(s) when assessing possible uses (i.e., in-use or in-exchange). A reporting entity should use judgment about expected use of assets based on the nature of the assets, prior history, knowledge about the market, or other relevant information.

Question 4-3: Should a reporting entity consider disposition costs in determining the fair value measurement in the principal (or most advantageous) market?

PwC Interpretive Response

FAS 157 provides guidance on the appropriate accounting for incremental direct costs to sell an asset or transfer a liability, concluding that, absent other applicable GAAP, such costs should be excluded from the fair value measurement. However, for certain assets, such as real estate, market participants may assume that an asset will be sold after a holding period. Therefore, in determining fair value, a market participant will often include the disposal costs associated with selling the real estate at the end of the holding period in its estimation of fair value. These disposal costs represent a buyer’s cost (i.e., market participant’s cost), which should be considered when determining what the buyer is willing to pay the reporting entity (i.e., the exit price).

4.1.5 Valuation of Assets (Valuation Premise)

In determining the fair value of an asset, FAS 157 introduces the concept of a valuation premise as either in-use or in-exchange. The valuation premise is established based on the highest and best use of the asset from the perspective of a market participant, which may be different from the reporting entity’s intended use. For example, a company’s management may intend to operate a property as a bowling alley, while market participants would consider a parking lot the highest and best use of the property. In that case, the fair value of the property should be based on the property’s use as a parking lot.

FAS 157 introduces two approaches to determining the highest and best use of an asset:

- **In-use:** The highest and best use of an asset is in-use if the asset would provide maximum value to market participants principally through its use with other assets as a group. That may be the case for an operating (nonfinancial) asset that provides maximum value principally through its use in combination with other operating assets of the reporting entity as a group. In that case, the fair value of the asset group is determined by using the in-use valuation premise. FAS 157 clarifies that even in a situation where the in-use valuation premise is applicable, the fair value measurement is still a market-based measurement determined based on the use of the asset by market participants.
- **In-exchange:** The highest and best use of an asset is in-exchange if the asset would provide maximum value to market participants principally on a stand-alone basis. That may be the case for a financial asset that provides maximum value separate and apart from the other assets of the reporting entity.
The in-use valuation premise may apply to a single unit of account, such as a reporting unit, if the underlying assets are being used in a group. It also applies when combining multiple reporting units. The valuation premise should be determined based on the specific circumstances. Once the exit market has been determined, market participant assumptions for each valuation premise are developed.

The interaction between the valuation premise and the principal or most advantageous market is an iterative process. In addition, determination of the appropriate valuation premise may result in aggregating assets across different units of account. The interaction between the unit of account and the valuation premise is complex and has been the subject of recent discussions at the FASB. Those discussions were in response to questions from constituents and the FASB Valuation Resource Group regarding the interpretation of the guidance in FAS 157. Specific issues and related guidance in this area are further discussed in Section 4.1.5.2, “Interaction of Unit of Account and Valuation Premise,” below.

4.1.5.1 Restricted Assets

If a reporting entity holds an asset that has restrictions on its sale or transferability (i.e., a restricted asset), the fair value measurement should be adjusted to reflect the discount, if any, a market participant would require as a result of the restriction. The impact of a restriction on the sale or use of an asset depends on whether the restriction would be considered by market participants in pricing the asset.

Example 9 of FAS 157 illustrates the impact of a contractual restriction on the use of donated land to a not-for-profit organization. In the example, the not-for-profit organization determines that the contractual restriction on how the land must be used would not legally transfer to market participants if the land were to be sold. Therefore, in the example, the asset restriction is specific to the not-for-profit organization and another owner could use the land for other purposes based on zoning where it is located. In this case, the restriction is not considered in the valuation of the land since the restriction would not be considered by market participants when determining the fair value of the land.

4.1.5.2 Interaction of Unit of Account and Valuation Premise

The unit of account represents what is being valued, based upon other relevant GAAP for the asset or liability being measured. Individual units of account should be aggregated to achieve their highest and best use. In addition to addressing the concept of aggregation, paragraph 6 and footnote 8 of FAS 157 also refer to the level at which an asset or liability is “disaggregated.” FAS 157, paragraph 6, states, in part:

The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements.
Footnote 8 states:

The fair value of an asset in-use is determined based on the use of the asset together with other assets as a group (consistent with its highest and best use from the perspective of market participants), even if the asset that is the subject of the measurement is aggregated (or disaggregated) at a different level for purposes of applying other accounting pronouncements.

A unit of account may be grouped with other units of account to achieve the highest and best use from the perspective of market participants. Account groupings must be established from the perspective of market participants. A unit of account may not be included in more than one group in the final determination of fair value. However, in considering potential markets, a reporting entity may need to consider whether different groupings of assets would provide a higher value from the perspective of a market participant. Finally, asset groupings must be premised on the fact that the reporting entity has access to the market into which an in-use grouping would be sold.

Disaggregation is the process of determining the fair value of a unit of account based on the individual sale of its components (e.g., each unit included in a forward contract for the purchase of a commodity rather than the entire quantity committed under the contract). This may be the case if a unit of account can be disaggregated and sold in components that would maximize the value of the unit of account from the perspective of market participants. As with asset groupings, the reporting unit must have access to the market into which components of units of account would be sold.

**PwC Observation:** We believe caution should be exercised when estimating values on this basis. The references provided above are unclear as to the support for disaggregation and have been the cause of some confusion when applying the Standard. However, in a case where a reporting entity has a strong fact pattern supporting that market participants purchasing at the unit of account level would then disaggregate to realize value, we believe an asset may be valued on that basis because it represents the highest and best use for the asset. In addition, if an asset is customarily sold at a level below the full unit of account, a reporting entity may consider the market(s) into which the components of the unit of account are sold as an indication of the value of the asset. However, the asset must be valued in its current form and any transformation or value adding activity must be subtracted when determining its fair value.

When applying the concepts of both aggregation and disaggregation, it is critical to ensure that the ultimate valuation relates solely to the unit of account. Following are examples to illustrate the concept:
Example 4-3
Unit of Account – Oil into Gasoline

Assume a company in the business of refining oil into gasoline enters into a contract to purchase a quantity of crude oil and the contract qualifies as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). When determining the fair value of the contract for crude oil, is the company permitted to consider the market for gasoline product as the principal market into which the crude oil is sold?

Evaluation

We do not believe that valuation of crude oil on the basis of the price of gasoline is an appropriate application of principal market and highest and best use in this fact pattern. The unit of account for the crude oil contract is established by FAS 133 as the entire contract for the crude oil. The conversion of the crude oil into gasoline would not provide an appropriate valuation, because the price differential relates primarily to the process of converting crude oil to gasoline and not to the unit of account. In this example, we would expect the potential markets for the crude oil contract to be based on the wholesale markets to which the crude oil can be transported.

Example 4-4
Unit of Account – Portfolio of Whole Loans

A company is estimating the fair value of a portfolio of whole loans. The company has access to both the whole loan market and to the securitization market. The company has historically sold a majority of its loans through the securitization market. The company determines that the whole loan market is not its principal market. Is the securitization market an appropriate market for use in valuing whole loans under FAS 157?

Evaluation

A portfolio of whole loans may be aggregated and “transformed” into securities that are sold in a transaction that initially involves a “true sale” by the reporting entity of the entire portfolio of loans to a trust, with the subsequent sale of beneficial interests in the loans to investors (disaggregation). We believe that a reporting entity that has access to the securitization market may consider the securitization market in the determination of the most advantageous market for the sale of whole loans. This can be supported by reference to the sale of the portfolio of loans as representing the sale of a grouping of separate units of account (a portfolio of whole loans) into a new trust, which is then disaggregated and sold as beneficial interests in the a trust. However, this process involves costs and a recognition of value that should be estimated and subtracted from the fair value attributed to the unit of account (the individual whole loan). Example 2 of Appendix A to FAS 157 provides support for the
conversion of a unit of account when market participant assumptions support an alternative use.

This guidance is consistent with guidance provided by the SEC staff and FASB staff at the 2007 AICPA Banking Conference. In their remarks, the SEC staff and FASB staff highlighted that measurement under FAS 157 should be focused on the asset or liability that is being valued, and not what the asset or liability may become. However, it may be a reasonable valuation methodology for a reporting entity to incorporate assumptions and impute a price by working backward from a downstream outcome, such as from prices for refined oil in developing a price for crude oil or from securitization prices for beneficial interests in developing a price for whole loans.

We address certain questions about the interaction of unit of account and valuation premise as follows:

**Question 4-4: How does the concept of unit of account interact with the valuation premise?**

**PwC Interpretive Response**

The unit of account establishes what is being measured, while the valuation premise is intended to determine the fair value based on a concept of highest and best use. In practice, there may be differences between the unit of account and the valuation premise. Therefore, a reporting entity must understand the interaction of these two key concepts.

The unit of account determines what is being measured for purposes of recognition in the financial statements by reference to the level at which the asset or liability is aggregated or disaggregated when applying other applicable GAAP. A reporting entity must go through the fair value framework to establish the principal, most advantageous, or hypothetical market and determine whether the valuation premise is in-use or in-exchange.

For assets valued in-exchange, the unit of account and the valuation premise are frequently the same. For assets valued in-use, the unit of account and valuation premise may be different and the valuation must then be allocated to the individual units of account included within the group.

**Example 4-5**

**Unit of Account and Valuation Premise**

Assume a company is performing step 1 of its annual impairment test of goodwill pursuant to FASB Statement No. 142, *Goodwill and Other Intangible Assets* (FAS 142). Further, assume that the company has goodwill allocated among multiple reporting units. For purposes of performing step 1 of the goodwill impairment test, FAS 142 specifies that the test should be performed for the reporting unit as a whole; this establishes the unit of account for purposes of the fair value measurement.
Management evaluates the potential markets and market participants and determines that it (1) may sell the individual reporting units separately or that (2) the aggregation of two reporting units may provide the highest value to market participants. Furthermore, the company does not have a principal market for the sale of its reporting units. Therefore, management determines that there are two potential markets – one in-use and one in-exchange. Management calculates the value of the two potential markets as follows:

1. **Market one – sale of the individual reporting units** – Each unit has an exit price of $100 million (for a total of $200 million).
2. **Market two – sale of the reporting units together** – The exit price increases to $220 million.

Based on this analysis, management concludes that the in-use valuation premise (i.e., sale of the two asset groups) provides the maximum value from the perspective of market participants. However, the unit of account for the asset being measured is the individual reporting unit. Therefore, the additional value of $20 million realized by aggregating the reporting units into their highest and best use must be allocated to the individual units of account. The value should be allocated based on management’s judgment as to the contribution of each unit of account to the combined total. See additional guidance on combining reporting units in the goodwill impairment test in Question 9-8.

**Question 4-5: When is it appropriate to apply the in-use valuation premise for financial assets and financial liabilities?**

**PwC Interpretive Response**

The highest and best use for financial assets is often determined to be in-exchange. However, the in-use concept is central to how certain assets are traded and/or valued. This is particularly true for items that trade in pools of relatively homogeneous items.

The following are examples of the potential application of the in-use valuation premise to financial assets and financial liabilities. Evaluating the facts and circumstances is critical in determining the appropriateness of the in-use approach to valuation. Accordingly, the examples presented may not be applicable by analogy to all cases.

**Mortgage Loans**

Mortgage loans often are pooled and sold/securitized with other loans with similar characteristics. The market for secondary mortgages is highly efficient at predicting cash flows on pools of loans but largely inefficient at predicting cash flows on any single loan. Uncertainty in cash flow projections is a major driver of the value of these assets. Furthermore, individual loans may be too small to be traded in a liquid market. Assuming the holder has access to the securitization market, it may be appropriate to value certain mortgage loans by using an in-use valuation premise assuming they will be either sold or securitized as part of a pool of loans. (See further discussion in Example 4-4.)
Insurance or Guarantee Risks

Insurance or guarantee risks often are evaluated and priced as pools of risk. The market for assuming such risk can predict with reasonable accuracy the expected losses on car insurance for a large pool of drivers, but is largely inefficient at predicting losses on a driver-by-driver basis. Again, uncertainty in cash flow projections is a major driver in the valuation of these liabilities. Accordingly, it may be appropriate to value insurance or guarantee liabilities assuming the transfer of a related pool of risk associated with multiple contracts by using the in-use valuation premise.

Collateral Associated with a Derivative Portfolio

The nonperformance risk of a portfolio of derivatives may be mitigated by collateral or netting agreements. If these types of arrangements exist, it may be appropriate to consider the reduction in net credit exposure in the valuation of the underlying derivatives as a group.

Liquidity Risk Associated with a Derivative Portfolio

A financial institution may evaluate liquidity risk on its portfolio of derivatives on a net position basis rather than for each position. The basis for this approach is that in most cases the institution would transfer its derivative positions only on a net basis. Thus, it may be appropriate to apply a “liquidity adjustment” on a net derivative position.

Question 4-6: How should a reporting entity allocate valuation adjustments under an in-use premise when the unit of account is the individual transaction?

**PwC Interpretive Response**

Certain types of valuation adjustments (e.g., credit or liquidity adjustments) may be determined at a portfolio level. In cases where the valuation allowance is recorded on an aggregate basis for a portfolio of assets, the reporting entity may need to attribute valuation adjustments to individual transactions for financial reporting purposes. Reporting entities should adopt a reasonable, practical policy to allocate valuation adjustments to individual units of account and should apply the policy consistently.

Question 4-7: When determining the highest and best use of an asset, what costs should be included in the fair value measurement?

**PwC Interpretive Response**

When determining the highest and best use of an asset, a reporting entity should consider potential markets, including reasonable scenarios using both the in-use and in-exchange valuation premises. The fair value of the asset should be determined based on the valuation premise and market that yields the highest net proceeds. Once the reporting entity has identified potential markets and the related valuation premise, the entity should calculate the fair value in each market, including all costs that market participants would incur in the circumstances. The following example illustrates this concept:
Example 4-6  
Costs Included in Market Determination

For example, if a parcel of land zoned for agricultural use is currently used for farming, the fair value should reflect the cost structure to continue operating the land for farming, including any tax credits that could be recognized by market participants.

However, if it is determined that market participants would consider an alternate use for the land, such as commercial or residential use, the fair value should include all costs (e.g., legal costs, viability analysis, traffic studies), associated with rezoning the land from agricultural use to the market participant’s intended use. In addition, demolition and other costs associated with preparing the land for a different use should be included in the estimate of fair value. This concept is illustrated in Example 2 of Appendix A to FAS 157. An effort to rezone land contains an element of uncertainty related to whether the proposed rezoning obtains approval. Therefore, the fair value of the land should also consider this uncertainty.

4.1.6 Valuation of Liabilities

In accordance with FAS 157, the fair value of a liability is based on the price to transfer the obligation to a market participant at the measurement date. FAS 157, paragraph 15, states in part:

A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the nonperformance risk relating to that liability is the same before and after its transfer. Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Therefore, the fair value of the liability shall reflect the nonperformance risk relating to that liability. Nonperformance risk includes but may not be limited to the reporting entity’s own credit risk.

The fair value measurement of a liability is not affected by how the reporting entity intends to settle the liability. Instead, the fair value measurement should reflect the market participants’ estimate of discounted future cash outflows for the liability, including adjustments for uncertainty. Liability measurements at fair value should reflect the effect of a reporting entity’s credit risk. Note that a reporting entity’s credit rating is not necessarily equivalent to its valuation of credit risk. Credit valuations can change independent of a change in credit rating (e.g., credit spreads may fluctuate without a corresponding change in credit rating). Paragraph A32 in Appendix A of FAS 157 further explains the impact that a change in credit standing has on the valuation of a liability and illustrates how to measure the fair value of a structured note payable.

In addition, in assessing the effect of nonperformance risk, reporting entities should consider the terms of any collateral and other credit enhancements that are specified in the contract for the liability or are otherwise attributes of the liability that is being measured.
PwC Observation: In response to the exposure draft that preceded FAS 157, many constituents expressed concern about the relevance of the reporting that would result if a liability remeasurement were to reflect the effect of changes in a reporting entity’s credit standing resulting in gains for credit downgrades and losses for credit upgrades. The concern focused on situations in which the company is experiencing financial difficulty and may not have the ability to realize the gains resulting from its credit deterioration. The Board believes that these concerns may indicate that fair value may not be the appropriate measure for a liability in certain circumstances. Accordingly, the Board plans to separately consider, on a project-by-project basis, whether fair value is the appropriate measurement attribute for measuring a liability.

The Board and its staff have also discussed liabilities for which market participants would give little or no consideration to credit when pricing the liability. We believe that credit is a key component of valuation and must be evaluated as a pricing input from the perspective of market participants. However, there may be obligations for which pricing inputs would not be impacted by credit. At its November 14, 2007 meeting, the Board directed the staff to proceed with an effort to provide additional guidance on the valuation of liabilities in general under FAS 157. Reporting entities should continue to monitor developments in this area.

Specific issues with respect to applying the fair value concepts to liabilities include the following:

Question 4-8: How does fair value measurement based on a transfer price differ from a valuation based on settlement of a liability with the counterparty?

PwC Interpretive Response
The valuation premise for a liability measured at fair value is based on the price that would be paid to transfer the liability to a third party. The amount that would be required to pay a third party (of equivalent credit or nonperformance risk) to assume a liability may differ from the amount that a reporting entity would be required to pay its counterparty to extinguish a liability.

For example, a financial institution transferee may be willing to assume non-demand-deposit liabilities for less than the principal amount due to the depositors because of the relatively low funding cost of such liabilities. However, in other instances, an additional risk premium above the expected payout may be required because of uncertainty about the ultimate amount of the liability (e.g., asbestos liabilities or performance guaranties). The risk premium paid to a third party may differ from the settlement amount the direct counterparty would be willing to accept. In addition, the party assuming a liability may have to incur certain costs to manage the liability or may require a profit margin.

These factors may cause the transfer amount to differ from the settlement amount. In measuring liabilities at fair value, the settlement amount may be the starting point if market participants would incorporate it in determining the fair value.
Question 4-9: How should a reporting entity incorporate its own risk of nonperformance into the valuation of its liabilities?

PwC Interpretive Response

A fair value measurement must incorporate the risk that an obligation will not be fulfilled. If a market participant would also consider this risk, it will affect the value at which a liability is transferred. A reporting entity’s own credit risk may be one of the key factors driving the risk of nonperformance and must be incorporated in the valuation of its liabilities; however, this requirement does not result in an automatic adjustment to all of its liabilities.

Credit risk, which is a component of nonperformance risk, may differ among liabilities of the same entity. For example, a company may have senior and subordinated debt, secured or unsecured debt, or debt of different legal entities that effectively have higher priority to key assets in the event of liquidation. Furthermore, short-term liabilities may have less inherent credit risk than long-term liabilities do. Other liabilities (e.g., derivative agreements) may be collateralized, may have netting agreements, or may be subject to third-party guarantees. All of these factors affect nonperformance risk and therefore should be considered in the valuation of a specific liability under FAS 157.

In considering nonperformance risk, the entity should capture the impact of the risk, including credit risk, on valuation of a liability by a market participant. This may involve the use of market-based credit spreads (i.e., the spread between yields on Treasury securities and securities with different quality ratings). However, as noted above, different liabilities of the same reporting entity may have different levels of credit risk; therefore, a reporting entity should consider the unique factors of individual liabilities in determining the appropriate level of credit risk to incorporate in the valuation.

Paragraphs 80 and 81 of FASB Statement of Financial Accounting Concepts No. 7, Using Cash Flow Information and Present Value in Accounting Measurements (CON 7), provide a helpful illustration of the effects of credit standing on a liability.

Third Party Guarantees

In order to consider a third party guarantee in valuing a liability, the guarantee must be an attribute of the instrument and must be inseparable from it. We believe that including third party guarantees in estimating the fair value of a liability is supported by paragraph 15 of FAS 157, which requires that the nonperformance risk relating to the liability be the same before and after its transfer. FAS 157, paragraph 15, also notes that the effect of an entity’s credit risk on the fair value of a liability may differ depending on, for example, “the terms of credit enhancements relating to the liability, if any.” In addition, CON 7, paragraph 79 states, in part:

… Liabilities that are guaranteed by governmental bodies (for example, many bank deposit liabilities in the United States) may pose little risk of default to the holder. Other liabilities may include… significant collateral. All of those aspects must be considered in estimating the extent to which the entity’s credit standing affects the fair value of its liabilities.
We are aware of an alternative view that third party guarantees, even if inseparable from the instrument, would not be included in the liability valuation in all instances. An example would be where the third party guarantee is payable directly to the holder of the instrument and not to the issuer. Under this view, the third party guarantee is not part of the liability itself, but is a separate instrument, and therefore is not a component of the fair value of the liability.

4.2 Fair Value at Initial Recognition

Certain accounting standards require or permit an asset or a liability to be initially recognized at fair value. Under the previous guidance provided by EITF 02-3, footnote 3, the recognition of Day One gains or losses was precluded in cases where fair value was based on significant unobservable inputs. This guidance was applicable to derivative instruments measured at fair value at initial recognition in accordance with the requirements of FAS 133. Key changes to the previous guidance as a result of adoption of FAS 157 include the following:

Figure 4-1
Impact of FAS 157: Day One Gains and Losses

<table>
<thead>
<tr>
<th>Previous Accounting</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>Based on entry / transaction price</td>
</tr>
<tr>
<td>Day one gains / losses</td>
<td>Not recognized if based on significant unobservable data</td>
</tr>
</tbody>
</table>

As further described below, the recognition of Day One gains and losses is not prohibited under FAS 157; however, additional disclosures are required when unobservable inputs are significant to the fair value measurement.

FAS 157 explicitly recognizes that the exit price may differ from the transaction price. In determining whether a transaction price represents the exit price at initial recognition, a reporting entity should consider factors specific to the transaction and to the asset or the liability. As discussed in FAS 157, paragraphs 16 and 17, a transaction price may not represent the fair value of an asset or liability at initial recognition if:

- The transaction is between related parties;
- The transaction occurs under duress or the seller is forced to accept the transaction price because of some urgency;
- The unit of account represented by the transaction price is different from the unit of account for the asset or liability that is measured at fair value (e.g., the transaction price includes transaction costs); or
The market in which the transaction occurs is different from the principal (or most advantageous) market in which the reporting entity would sell or otherwise dispose of the asset or transfer the liability (e.g., a retail market versus a wholesale market).

If the transaction involves one or more of the above factors, or if a difference between entry and exit price can be supported based on the valuation methodology used, a reporting entity may determine that the transaction price does not represent the fair value of the asset or the liability at initial recognition, resulting in recognition of a Day One gain or loss.

In addition, in certain situations, the fair value measurement of certain hybrid financial instruments may differ from the transaction price, resulting in an unrealized gain or loss as indicated by FAS 155. See Section 6.2.2, “Day One Gains and Losses under EITF 02-3,” for further discussion regarding the change in accounting for Day One gains and losses, and Chapter 7: Fair Value Option for further discussion of FAS 155.

### 4.3 Valuation Techniques

FAS 157 describes three main approaches to measuring the fair value of assets and liabilities: the market approach, the income approach, and the cost approach. While these approaches are not new, they are now codified into the framework for measuring fair value. The approaches are further described below:

#### 4.3.1 Market Approach

FAS 157, paragraph 18(a) defines the market approach as follows:

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative).

The market approach includes the use of matrix pricing. Matrix pricing is a mathematical technique that may be used to value debt securities by relying on the securities’ relationship to other benchmark quoted prices and is commonly used to price bonds.

#### 4.3.2 Income Approach

FAS 157, paragraph 18(b) defines the income approach as follows:

The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial
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model (a lattice model), which incorporate present value techniques; and
the multi-period excess earnings method, which is used to measure the fair
value of certain intangible assets. (footnotes omitted)

4.3.2.1 Interaction of FAS 157 with CON 7

As noted above, present value techniques are a type of income approach. FAS
157 neither prescribes the use of one specific present value technique nor
limits the use of present value techniques to measure fair value, instead
indicating that a reporting entity should use the appropriate technique based
on facts and circumstances specific to the asset or liability being measured.
However, FAS 157, Appendix B, discusses the use of present value
techniques in the determination of fair value. Appendix B clarifies and
incorporates the guidance that CON 7 provides regarding the use of present
value techniques to measure fair value. Those techniques include the
“discount rate adjustment” technique and the “expected present value”
technique.

In accordance with FAS 157, paragraph B2, the following key elements from
the perspective of market participants should be considered in developing a
fair value measurement using present value:

• Estimate of future cash flows;
• Expectations about possible variations in the amount and timing of cash
flows;
• The time value of money based on the risk-free rate for monetary assets
with maturity dates or durations that coincide with the period covered by the
cash flows;
• A risk premium due to uncertainty;
• Other factors that would be considered by market participants; and
• For a liability, the risk of nonperformance, including the reporting entity’s
own credit risk.

In discussing the appropriate discount rate, CON 7 implies that a risk-free
interest rate is the appropriate rate for discounting expected cash flows
adjusted for systematic risk (or nondiversifiable market risk). In FAS 157, the
Board clarified that it did not intend to preclude reflecting systematic risk in the
discount rate and specified that adjustments reflecting systematic risk can be
made to either (1) the expected cash flows or (2) the discount rate. The risk-
free rate would be an appropriate discount rate only if the adjustment that
reflects the systematic risk (non-diversifiable risk) is reflected in the expected
cash flows.

PwC Observation: In practice, adjusting the expected cash flows to reflect
systematic risk is often difficult. In most instances, therefore, the discount
rate that is applied to cash flows would incorporate systematic, or non-
diversifiable risk, which would often be represented by a weighted-average
cost of capital that would be required by a marketplace participant.
As a result of the incorporation of this guidance within FAS 157, the CON 7 guidance is now Level A GAAP, which is the highest level of authoritative guidance in the GAAP hierarchy. Reporting entities considering use of a present value technique should refer to FAS 157, Appendix B, for further guidance on application of these techniques, including additional considerations related to the incorporation of uncertainty, discount rate adjustment techniques, and use of expected present value techniques.

### 4.3.3 Cost Approach

FAS 157, paragraph 18(c), in part, defines the cost approach as follows:

> The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost).

The cost approach assumes that the fair value would not exceed what it would cost a market participant to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. In considering obsolescence, FAS 157, paragraph 18(c) specifies that this includes "physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence." Therefore, in using a replacement cost approach, a reporting entity would need to consider the impact of product improvements and changes in its assessment of the replacement cost.

### 4.3.4 Application of Valuation Techniques

FAS 157 does not prescribe which valuation technique(s) should be used when measuring fair value and does not prioritize among the techniques. Instead, FAS 157 states that reporting entities should measure fair value using the valuation techniques that are appropriate in the circumstances and for which sufficient data are available. The selection of appropriate valuation techniques may be affected by the availability of relevant inputs as well as by the relative reliability of the inputs.

In some cases, one valuation technique may provide the best indication of fair value (e.g., the use of the market approach in the valuation of an actively traded equity security); however, in other circumstances, multiple valuation techniques may be appropriate (e.g., in valuing a reporting unit for purposes of step 1 of a goodwill impairment test).

When reconciling multiple valuation techniques, there may be measurements for which one or more valuation techniques are not relevant either due to limited availability of inputs or based on the type of asset or liability being valued. Furthermore, the results of the application of the various techniques may not be equally representative of fair value, due to factors such as assumptions made in the valuation. In cases where multiple techniques are used, the reporting entity will need to evaluate and weigh the results, as appropriate, developing a range of possible results. The fair value will be based on the most representative point within the range in the specific circumstances.
As discussed in FAS 157, paragraph 20, reporting entities should consistently apply the valuation techniques used to measure fair value for a particular type of asset or liability. However, it is appropriate to change a valuation technique or its application if the change will result in a measurement that better represents fair value; for instance, a change in a particular technique’s weighting when multiple valuation techniques are used may be appropriate based on changes in facts and circumstances. A change in valuation technique may also be warranted as new markets develop, new information becomes available, and valuation techniques improve. Revised valuations resulting from a change in the valuation technique or its application are accounted for as a change in accounting estimate, with the change impacting the current and future periods, if applicable.

4.4 Inputs to Valuation Techniques

Inputs are used in applying the various valuation techniques and broadly refer to the assumptions that market participants use to make pricing decisions, including assumptions about risk. FAS 157 distinguishes between (1) observable inputs, which are based on market data obtained from sources independent of the reporting entity and (2) unobservable inputs, which reflect the reporting entity’s own assumptions about the assumptions market participants would use. FAS 157 emphasizes that a reporting entity’s valuation technique for measuring fair value should maximize observable inputs and minimize unobservable inputs, regardless of whether the reporting entity is using the market approach, income approach, or cost approach. Inputs may include price information, volatility factors, specific and broad credit data, liquidity statistics, and all other factors that have more than an insignificant effect on the fair value measurement.

4.4.1 Observable versus Unobservable Inputs

A determination of what constitutes “observable market data” will require significant judgment. We believe that observable market data comprises, in the following hierarchical order:

- Prices or quotes from exchange or listed markets (e.g., NYMEX, CBOT, or New York Stock Exchange (NYSE)) in which there is sufficient liquidity and activity;
- Proxy observable market data that is proven to be highly correlated and has a logical, economic relationship with the instrument that is being valued (e.g., electricity prices in two different locations, or “zones” that are highly correlated); and
- Other direct and indirect market inputs that are observable in the marketplace.

The following characteristics, if present, would provide evidence that data is market-based and observable:
The list of characteristics does not imply that all of these should be present to conclude that the evidence qualifies as observable market data. Judgment should be applied based on the preponderance of evidence.

**Characteristics Indicating That Data Is Observable**

- Not proprietary: The data incorporated into an input of a valuation technique should come from sources other than within the reporting entity that is making the determination. In addition, the data should be distributed broadly, and not limited in its distribution to only the entity that is making the determination or to a small group of users. The data should be available to and regularly used by participants in the relevant market/product sector as a basis for pricing transactions or verifying such prices (i.e., an assumption generated internally by a reporting entity should be comparable to the external data).

- Readily available: Market participants should be able to obtain access to the data, although the supplier of the information could impose a reasonable fee for access.

- Regularly distributed: The term “regular distribution” means that the data is made available in a manner that is timely enough to allow the data to be meaningful in pricing decisions. Further, there should be procedures in place to verify that changes between intervals have not occurred that would render the data meaningless. In addition, the distributed information should indicate its effective date to ensure that data received is not stale.

- From multiple independent sources: Relevant comparable data should be obtainable from multiple acceptable sources. For example, to obtain sufficient evidence, a reporting entity may utilize both multiple broker quotes and pricing services that aggregate information from a number of data providers. Also, to be meaningful, the sources of data should be independent of one another, not all drawn from the same original source. For exchange-traded items, all sources will come from the original exchange.
• Transparent: The people/sources providing and/or distributing the data and their role in a particular product/market should be transparent and known to be reliable. In addition, it needs to be clear to the people who provide the data that market participants use this information to price/verify transactions.

• Verifiable: The data should be verifiable. Further, there should be evidence that users are, in fact, regularly verifying the data. For example, people who are independent of a particular entity should be able to contact the third-party data provider directly in order to verify the data that is obtained and used. It also should be possible for people to verify the data by comparing it with data that is obtained from other reliable sources.

Characteristics Indicating That Data Is Market-Based

• Reliable: The data should reflect actual market parameters and be subject to certain levels of periodic testing and controls. These controls should exist at the entity that is providing the data, as well as at the entity that uses the data. Reporting entities should test and review the reliability of a source’s data on an ongoing basis before actually using that source as a basis for determining a fair value measurement.

• Based on consensus: The data or inputs that are provided by multiple sources should be comparable within a reasonably narrow range before an entity can safely regard the information as demonstrating a market consensus. The various items of data should be consistent with one another, with one source verifying other sources.

• Provided by sources actively involved in the relevant market: The data should originate from a source that is an active participant with respect to the relevant product and within the relevant market. Further, the entity that is using the data should periodically demonstrate that the source of the data provides reliable information on a consistent basis. Although there are instances in which market forces could help ensure that a data source provides reliable information, such assurance may need to be supplemented with other evidence, such as the results of back-testing that has been applied to verify the consistency and reliability of a particular source’s data.

• Supported by market transactions: Although data need not be traced directly to a “live” transaction or a “perfectly offsetting” transaction, there should be strong evidence that (1) the data sources draw their information from actual transactions or (2) the information is used by market participants to price actual market transactions. If data is in the form of a broker quote, for example, the broker should be known – based on substantial experience transacting through the broker – to reliably quote prices at which actual transactions can be executed.

The above guidance addresses only whether inputs for a valuation technique are based on observable data. Models that are used in a valuation technique that incorporate the inputs should be reviewed and reassessed on an ongoing basis to ensure that they reliably calculate an accurate fair value measurement.
4.4.1.1 Different Types of Markets with Observable Inputs

Markets in which inputs might be observable for some assets and liabilities (e.g., financial instruments) include the following:

- **Exchange market**: In an active exchange market, closing prices are both readily available and representative of fair value (e.g., NYSE closing prices are both readily available and representative of fair value).
- **Dealer market**: In a dealer market, dealers stand ready to trade for their own account, thereby providing liquidity by using their capital to hold an inventory of the items for which they make a market. Typically, bid prices and asked prices are more readily available than closing prices. Dealer markets also exist for other assets and liabilities, such as financial instruments, commodities, and physical assets.
- **Brokered market**: In a brokered market, brokers attempt to match buyers with sellers, do not stand ready to trade for their own account and do not use their own capital to hold an inventory of the items for which they make a market. For a broker quote to be observable, a reporting entity will need transparency into the market data used to develop the quote and to make a judgment as to whether the market data is observable.
- **Principal-to-principal market**: Principal-to-principal transactions (both originations and resales) are negotiated independently, with no intermediary. Often, very little information about these transactions is publicly available.

Entities should consider the characteristics of the underlying markets in assessing whether a valuation input is observable.

4.5 Fair Value Hierarchy

To increase consistency and comparability in fair value measurements, FAS 157 establishes a fair value hierarchy to prioritize the inputs used in valuation techniques. There are three broad levels to the fair value hierarchy of inputs to fair value (Level 1 being the highest priority and Level 3 being the lowest priority):

- **Level 1**: Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets;
- **Level 2**: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or indirectly; and
- **Level 3**: Unobservable inputs (e.g., a reporting entity’s own data).

By distinguishing between inputs that are observable in the marketplace, and therefore more objective, and those that are unobservable and therefore more subjective, the hierarchy is designed to indicate the relative reliability of the fair value measurements.

In some cases, a valuation technique used to measure fair value may include inputs from multiple levels of the fair value hierarchy. The lowest level of significant input determines the placement of the entire fair value measurement in the hierarchy. Assessing the significance of a particular input to the fair value measurement requires judgment, considering factors specific
to the asset or liability. Determining whether a fair value measurement is based on Level 1, Level 2, or Level 3 inputs is important because certain disclosures required by FAS 157 are applicable only to those fair value measurements that use Level 3 inputs. See further discussion of disclosure requirements in Chapter 5: Disclosures.

The key characteristics of each level of the fair value hierarchy are as follows:

**Figure 4-3**

**Fair Value Hierarchy**

The fair value hierarchy gives the highest priority to quoted prices in active markets and gives the lowest priority to unobservable inputs. Some of the key differentiating factors are:

*Level 1*

- Observable
- Quoted prices for identical assets or liabilities in active markets

*Level 2*

- Quoted; similar items in active markets
- Quoted, identical/similar items, no active market
- Must be observable for substantially the full term

*Level 3*

- Unobservable inputs (e.g., a company’s own data)
- Market perspective still required

Level 1 inputs should be used whenever available. Valuations using Level 3 inputs require significantly more disclosure.

See further discussion of the characteristics of each of the levels as follows:

**4.5.1 Level 1 Inputs**

Level 1 inputs are quoted prices (unadjusted) for identical assets or liabilities in active markets. A quoted price for an identical asset or liability in an active market (e.g., an equity security traded on the NYSE) provides the most reliable fair value measurement and, if available, should be used to measure fair value in that particular market.

As further discussed in Section 4.1.3, "Principal or Most Advantageous Market," the market determination is made from the perspective of the reporting entity and the availability of pricing inputs is not part of that assessment. For example, if the reporting entity is a retail customer and does not have access to the wholesale market, quoted prices in the wholesale market will not qualify as Level 1 inputs for that reporting entity. However, the availability of pricing inputs may impact the choice of valuation technique (e.g., if Level 1 inputs are available for a market approach, that approach may
provide more objective evidence of fair value than an income approach would). Furthermore, if Level 1 inputs are available within a particular market, those inputs should be prioritized over Level 2 or 3 inputs in the same market, except as further discussed below.

Paragraphs 25 through 27 of FAS 157 discuss other considerations when using Level 1 inputs as follows:

4.5.1.1 Level 1 Inputs – Large Number of Similar Assets and Liabilities

FAS 157, paragraph 25, provides a practical expedient for the fair value measurement of a large number of similar assets or liabilities (e.g., debt securities) for which quoted prices in active markets are available but not readily accessible. In accordance with this guidance, a reporting entity may measure fair value by using an alternative pricing method (e.g., matrix pricing) instead of obtaining quoted prices for each individual security, provided that the reporting entity demonstrates that the method replicates actual prices. If an alternative pricing method is used as a practical expedient, the resulting measurement will be a Level 2 input, not a Level 1 input.

4.5.1.2 Level 1 Inputs – Post-market Close Events

In some situations, significant events (e.g., principal-to-principal transactions, brokered trades, or announcements) may occur after the close of a market but before the measurement date. When that is the case, a quoted market price may not be representative of fair value on the measurement date. Reporting entities should establish and consistently apply a policy for identifying and incorporating events that may affect fair value measurements. In addition, if a reporting entity adjusts the quoted price, the resulting measurement will not be classified in Level 1, but will be a lower-level measurement.

**PwC Observation:** The measurement date, as specified in each accounting standard requiring or permitting fair value measurements, is the “effective” valuation date. Accordingly, a valuation should reflect only facts and circumstances that exist on the specified measurement date (these include events occurring before the measurement date or that were reasonably foreseeable on that date) so that the valuation is appropriate for a transaction that would occur on that date.

4.5.1.3 Level 1 Inputs – Blockage Factors

In accordance with FAS 157, the fair value of a position for a single financial instrument in an active market should be calculated as the product of the quoted price for the individual instrument times the quantity held. When measuring the fair value of a financial instrument that trades in an active market, FAS 157 prohibits the use of a blockage factor (a discount applied to reflect the inability to trade a block of the security because the market for the security, although an active one, could not absorb the entire block at one time without adversely affecting the quoted market price).

As discussed in FAS 157, paragraph C79, the FASB concluded that blockage factors should not be incorporated in the fair value as that introduces
management’s intent (i.e., to trade in blocks) into the measurement of fair value, which would reduce comparability. Accordingly, the Board concluded that the fair value of a quoted security or other financial instrument must be measured as the quoted price multiplied by the quantity held.

4.5.2 Level 2 Inputs

Level 2 inputs are inputs that are observable, either directly or indirectly, but do not qualify as Level 1. In accordance with FAS 157, paragraph 28:

Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)

c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

d. Inputs that are derived principally from or corroborated by observable market data through correlation or by other means (market-corroborated inputs)

Adjustments to Level 2 inputs should include factors such as the condition and/or location of the asset or the liability on the measurement date and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement may place the measurement in Level 3 in the fair value hierarchy.

PwC Observation: Certain inputs derived through extrapolation or interpolation may be corroborated by observable market data (e.g., extrapolating observable 1- and 2- year interest rate yields to derive 3-year yields) and would be considered a Level 2 input. For example, assume that the Argentinean interest rate yield curve is correlated to the Chilean interest rate yield curve. Also assume that the Argentinean yield curve is observable for three years but the Chilean yield curve is observable for only two years. A company could extrapolate the third year of the Chilean yield curve based on the extrapolation of the Chilean yield curve from years one and two and the correlation of the third year Argentinean yield curve. The Chilean yield for year 3 in this example would be considered a Level 2 input. However, extrapolating short term data to measure longer term inputs may require assumptions and judgments that cannot be corroborated by observable market data and therefore, may represent a Level 3 input.
4.5.3 Level 3 Inputs

FAS 157, paragraph 30, in part, defines Level 3 inputs as follows:

Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity’s own data.

Level 3 inputs may include information derived through extrapolation or interpolation that cannot be corroborated by observable market data. In developing Level 3 inputs, a reporting entity need not undertake all possible efforts to obtain information about market participant assumptions; however, it should not ignore information that is reasonably available without undue cost and effort. Therefore, if a reporting entity uses its own data to develop Level 3 inputs, that data should be adjusted if information is reasonably available that indicates that market participants would use different assumptions.

Due to the amount of judgment involved in categorizing an input within the fair value hierarchy, a number of questions arise in application:

**Question 4-10: How is an active market defined in assessing the classification of an input in the fair value hierarchy?**

**PwC Interpretive Response**

The determination of whether inputs are observable is one of the key factors that will impact the classification of an input within the hierarchy. The level of activity in the market will contribute to the determination of whether an input is observable.

FAS 157, paragraph 24, defines an active market as one in which transactions for the asset or liability being measured occur often enough and with sufficient volume to provide pricing information on an ongoing basis. However, an observable input that may otherwise be a Level 1 input will be rendered Level 2 if the information relates to a market that is not active. FAS 157, paragraph 28(b), in part, outlines characteristics of an inactive market as follows:

… markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)

For example, in assessing market inputs, consider a security for which aggregate broker data is published on occasion, and for which trading does
not occur on a regular basis. In this case, the price is quoted only occasionally and the security is not regularly traded. In determining the level of inputs within the hierarchy, the company should consider what recent activity the quote is based on, as well as trading volume trends. While all of the facts and circumstances need to be examined, the information provided in this example appears to indicate the quote is a Level 2 or Level 3 input.

**Question 4-11: Does the valuation technique selected impact the classification of the fair value measurement within the fair value hierarchy?**

**PwC Interpretive Response**

The FAS 157 fair value hierarchy prioritizes the inputs to the valuation techniques, not the valuation techniques themselves. Selecting the appropriate valuation technique(s) should be based on an assessment of the facts and circumstances specific to the asset or liability being measured and should be independent of the classification of inputs used within the fair value hierarchy. A reporting entity is required to use those valuation techniques that are appropriate in the circumstances and for which inputs are available without undue cost.

**Question 4-12: What is the impact of the use of valuation models on the classification within the fair value hierarchy?**

**PwC Interpretive Response**

Reporting entities commonly use proprietary models to calculate fair value measurements impacted by FAS 157, including some long-term derivative contracts, impairments, and illiquid investments such as real estate. Models may also be used to perform other fair value measurements, such as those required for asset retirement obligations or impairments of long-lived assets. The level within the hierarchy is determined based on the valuation inputs, not on the methodology or complexity of the model. However, certain valuations may require the use of complex models to develop forward curves and other inputs; therefore, the models and inputs are frequently inextricably linked.

The use of a model does not automatically result in a Level 3 fair value measurement. For example, a standard valuation model used to compute a value by using all observable inputs is likely to result in a measurement that is classified as Level 2. However, to the extent that adjustments or interpolations are made to Level 2 inputs in an otherwise standard model, the measurement may fall into Level 3, depending on whether the adjusted inputs are significant to the measurement. Furthermore, if a reporting entity uses a valuation model that is proprietary and relies on unobservable inputs, the resulting fair value measurement will be categorized as Level 3.

For example, consider the measurement of a financial asset that is not actively traded. The valuation is performed using a proprietary model using unobservable inputs. However, while the financial asset is not actively traded, assume the broker providing the inputs to be used in the model is standing ready to transact at the quoted price and/or sufficient corroborating data is obtained. Provided the model does not include management assumptions used to make adjustments to the data, it may be reasonable to conclude that the inputs, and thus the measurement, would be classified as a Level 2 fair
value measurement. However, if the company is required to develop a forward price curve because the duration of the contract exceeds the length of time that observable inputs are available, or is otherwise required to make adjustments to observable data, the valuation is relying on Level 3 inputs and would be classified as a Level 3 fair value measurement if those inputs are significant to the overall fair value measurement.

**Question 4-13: How does the use of a pricing service or broker quotes impact the classification of an input in the fair value hierarchy?**

**PwC Interpretive Response**

Many reporting entities obtain information from pricing services, such as Bloomberg, Interactive Data Corporation, Loan Pricing Corporation, Markit’s Totem Service, broker pricing information, and similar sources, for use as inputs in their fair value measurements. The information provided by these sources could be any level in the fair value hierarchy, depending on the source of the information for a particular security.

The following figure summarizes the classification of some common sources of pricing inputs:

**Figure 4-4**

**Where do the prices fall?**

Some typical examples of inputs used, and their classification in the fair value hierarchy include:

**Level 1**
- New York Stock exchange prices for securities
- NYMEX futures contract prices

**Level 2**
- Posted or published clearing prices, if corroborated
- A dealer quote for a non-liquid security, provided the dealer is standing ready and able to transact

**Level 3**
- Inputs obtained from broker quotes that are indicative (i.e., not being transacted upon) or not corroborated
- Models that incorporate management assumptions that cannot be corroborated with observable market data

The above are examples of inputs that may be considered appropriate for the levels indicated. However, the facts and circumstances applicable to the measurement should always be assessed.
Classification within the hierarchy is further discussed as follows:

**Level 1 Inputs**

Generally, for a price or other input to qualify as a Level 1 input, reporting entities should be able to obtain the price from multiple sources. Level 1 inputs relate to items traded on an exchange or an active index/market location.

**Level 2 and Level 3 Inputs**

In some cases, reporting entities may rely on pricing services or published prices that represent a consensus reporting of multiple brokers. It may not be clear if the prices provided can be transacted upon. In order to support an assertion that a broker quote or information obtained from a consensus pricing service represents a Level 2 input, the entity should typically perform due diligence to understand how the price was developed, including understanding the nature and observability of the inputs used to determine that price. Additional corroboration could include:

- Discussions with pricing services, dealers, or other entities to collect additional prices of identical or similar assets to corroborate the price;
- Back-testing of prices to determine historical accuracy; and
- Comparisons to other external or internal valuation model outputs.

The level of due diligence performed is highly dependent on the facts and circumstances, such as the type and complexity of the asset or liability being measured, as well as its observability and liquidity in the marketplace. Generally, the more unique the asset or liability being measured and the less liquid it is, the more due diligence will be necessary to corroborate the price in order to support classification as a Level 2 input.

Determining the amount and type of due diligence to be performed is a matter of judgment, and reporting entities should clearly document the assessment performed in arriving at their conclusions. Without additional supporting information, prices obtained from a single broker or a pricing service are indicative values or proxy quotes, and we believe such information generally represents Level 3 inputs.

Finally, it is important to note that an entity must have some higher-level data to support classification of an input as Level 2. A broker quote for which the broker does not stand ready to transact cannot be corroborated with an internal model populated with Level 3 information to support a Level 2 classification. However, there may be other instances where pricing information can be corroborated by market evidence, resulting in a Level 2 input.

**Other Considerations**

Ultimately, it is management’s responsibility to determine the appropriateness of its fair value measurements and their classification in the fair value hierarchy, including instances where pricing services are used. Therefore, reporting entities that use pricing services will need to understand how the
pricing information has been developed and obtain sufficient information to be able to determine where instruments fall within the fair value hierarchy.

Examples

For example, a pricing service could provide quoted prices for an actively traded equity security, which would be a Level 1 input. The same pricing service may also provide a corporate bond price based on matrix pricing, which may constitute a Level 2 or Level 3 input depending on the information used in the model.

In another example, a reporting entity may obtain a price from a broker for a residential mortgage-backed security. The reporting entity may be fully aware of the depth and liquidity of the security’s trading in the marketplace based on its historical trading experience. In addition, the pricing methodology for the security may be common and well understood (e.g., matrix pricing) and therefore less due diligence may be required. However, a similar conclusion may not be appropriate in all instances (e.g., a collateralized debt obligation that is not frequently traded and does not have liquidity in the marketplace).

Question 4-14: Where are fair value measurements based on real estate appraisals and similar valuation techniques classified within the fair value hierarchy?

PwC Interpretive Response

The level of a real estate appraisal within the fair value hierarchy will vary by the type of asset and the inputs. For example, a multi-unit condominium development in which each unit has similar floor plans, features, and few differentiating characteristics, may be measured using an appraisal based on a market approach that incorporates an observable dollar-per-square-foot multiple. As long as the multiple is observable and not adjusted in any way, the valuation would represent a Level 2 fair value measurement.

However, the valuation of many real estate assets – such as office buildings, shopping centers, hospitals, manufacturing facilities, and similar build-to-suit facilities – requires adjustments to market-based valuation inputs, to reflect the different characteristics between the assets being measured and the assets upon which the observable inputs are based. These adjustments could result in classification as a Level 3 fair value measurement for the real estate asset. Real estate assets may also be measured using an income approach based on unobservable cash flows to be received from expected rents and expenses, which would likely also yield a Level 3 fair value measurement.

In considering information from appraisals, the reporting entity should also ensure that the third-party valuation specialist appropriately evaluated and documented the highest and best use of the asset.
**Question 4-15: How should a reporting entity assess the significance of an input in determining the classification of a fair value measurement within the fair value hierarchy?**

**PwC Interpretive Response**

In describing the fair value hierarchy, FAS 157, paragraph 22 states, in part:

> The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

For example, an input could be unobservable and have little impact on the valuation at initial recognition, but the same input could have a significant remeasurement impact if markets and related assumptions change.

The valuation of many assets and liabilities necessarily involves inputs from two or more levels within the hierarchy. Determining the significance of a particular input to a fair value measurement is a matter of judgment. A starting point is to have a basic understanding of all of the inputs that factor into the fair value measurement, the relative significance of each of the inputs, and whether those inputs are externally verifiable or are derived through internal estimates.

There are no bright lines for determining significance, and two different entities may determine that the same facts lead to different conclusions. Paragraph A24 of FAS 157 provides an example whereby an interest rate swap with a ten-year life has an observable yield curve for nine years. In that example, provided that the extrapolation of the yield curve to ten years is not significant to the fair value measurement of the swap in its entirety, the fair value measurement is considered Level 2. In this example, the final year of the instrument, representing ten percent of the term was judged as not being a significant input. We believe a reporting entity should consider the impact of lower level inputs on the fair value measurement at the time the measurement is made, as well as the potential impact on future movements in the fair value.

In assessing the significance of unobservable inputs to an asset or liability’s fair value, a reporting entity should (1) consider the sensitivity of the asset or liability’s overall value to changes in the data and (2) reassess the likelihood of variability in the data over the life of the asset or liability. Additionally, we believe that the assessment should be performed on both an individual and an aggregate basis when more than one item of unobservable data (or more than one parameter) is used to measure the fair value of an asset or liability. This assessment will depend on the facts and circumstances specific to a given asset or liability and will require significant professional judgment.

Given the level of judgment that may be involved, a reporting entity should document its rationale when the determination of the classification of inputs in the fair value hierarchy is not straightforward. In addition, a reporting entity should develop and consistently apply a policy for determining significance.
Question 4-16: Are there any specific considerations in using Level 3 inputs in a valuation?

PwC Interpretive Response

A valuation technique used to measure the fair value of an asset or a liability should reflect assumptions a market participant would use to price the asset or liability, including assumptions about risk. FAS 157, paragraph A25, in part, provides guidance on the use of Level 3 inputs as follows:

Level 3 inputs are unobservable inputs for the asset or liability, that is, inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability (including assumptions about risk) developed based on the best information available in the circumstances. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique.¹⁵ (emphasis added)

FAS 157, footnote 15 further states, “A measurement (for example, a ‘mark-to-model’ measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.”

If market participants would place a discount on an asset value (or require a premium on a liability value) because of uncertainty relating to the valuation technique or the inputs, then the measurement should be adjusted for that risk. Paragraph C16 of FAS 157 states, in part:

…this Statement clarifies that the measurements should be adjusted for risk, that is, the amount market participants would demand because of the risk (uncertainty) inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique (a risk premium notion).

Many fair value measurements developed using Level 3 inputs are based on cash flow projections, which are unobservable. A reporting entity should consider whether adjustments are required when using inputs that are not observable. Cash flow projections may be conditional and generally reflect some level of uncertainty. Market participants generally require compensation for bearing this risk of uncertainty, and the associated risk premium should be reflected in the fair value measurement.

Determining the appropriate amount of the adjustment for risk to inputs and valuations can be complex. These risk adjustments are typically required in situations when pricing inputs are unobservable. As a result, determining what a hypothetical market participant would demand as a risk adjustment may be difficult. In these situations, a reporting entity could consider itself or similar entities as a proxy for market participants. In determining the appropriate adjustment, a reporting entity should look beyond its own policies and consider the type of adjustments a market participant would require for that period.

A reporting entity may want to consider the following methods, as applicable, to incorporate market participant assumptions when using Level 3 inputs:
• Calibrate models against recent transactions of similar duration to provide additional evidence of expected pricing beyond observable market inputs.

• Incorporate common industry conventions (e.g., use of quoted default rates to establish credit reserves, use of the risk-free rate to discount) if these inputs are consistent with its expectations of market participant pricing points.

• Consider history and the settlement of past transactions to determine how effective the entity has been at applying reserve and proprietary modeling techniques.

In addition, a reporting entity should consider whether market participants would demand an additional premium to compensate for the uncertainty associated with certain transactions.

**Question 4-17: Does the FAS 157 prohibition of the use of blockage factors when measuring the fair value of a financial instrument that trades in an active market (i.e., Level 1 inputs) also apply to Level 2 and Level 3 inputs?**

**PwC Interpretive Response**

FAS 157, paragraph C79, in part, discusses the Board’s decision to preclude the use of blockage discounts when using Level 1 inputs as follows:

Basing the fair value on the quoted price results in comparable reporting. Adjusting the price for the size of the position introduces management intent (to trade in blocks) into the measurement, reducing comparability. … Also, the decision to exchange a large position in a single transaction at a price lower than the price that would be available if the position were to be exchanged in multiple transactions (in smaller quantities) is a decision whose consequences should be reported when the decision is executed.

However, FAS 157, paragraph C80, further states:

This Statement amends Statements 107, 115, 124, 133, and 140 to remove the similar unit-of-account guidance in those accounting pronouncements, which referred to a fair value measurement using PxQ for an instrument that trades in any market, including a market that is not active, for example, a thin market (within Level 2). In this Statement, the Board decided not to specify the unit of account for an instrument that trades in a market that is not active. The Board plans to address unit-of-account issues broadly in its conceptual framework project.

When considering whether a blockage factor is appropriate when using Level 2 and Level 3 inputs, we believe that a reporting entity should consider the specific facts and circumstances and the Board’s logic and reasoning for precluding blockage factors for Level 1 inputs. For example, a blockage factor may be appropriate for a holding in a technology company that is thinly traded and for which a market participant would be willing to transact only in a block. In other cases, a blockage factor may not be appropriate if the discount introduces an element of management intent in terms of planned disposition.
Finally, when considering valuation of financial instruments, a reporting entity should prioritize Level 1 inputs when available, although this may subject the entity to the blockage requirements.

4.5.4 Inputs Based on Bid and Ask Prices

Bid-ask price quoting is common within markets for certain securities, financial instruments, and commodities. In these markets, dealers stand ready to buy at the bid price and sell at the ask price. If an input within the fair value hierarchy is based on bid prices and ask prices, the fair value measurement should represent the price within the bid-ask spread at which market participants would transact on the measurement date. FAS 157 provides a practicability exception to this principle, allowing the use of mid-market pricing or other pricing conventions as a practical expedient for fair value. A reporting entity may also establish a policy to use bid prices for long positions (assets) and ask prices for short positions (liabilities). Once established, a reporting entity should follow its accounting policy consistently.

Many reporting entities currently use or are contemplating the use of the mid-market convention as permitted by FAS 157 because it simplifies some of the necessary calculations and allows use of the same quotes and prices when calculating the fair value of both assets and liabilities. As a result of the diversity in practice and the changes created by the new guidance, the following questions arise with respect to the FAS 157 bid-ask spread guidance:

**Question 4-18: Can a reporting entity change its policy with respect to the use of the mid-market pricing convention at the time of adoption of FAS 157?**

**PwC Interpretive Response**

FAS 157 provides the following guidance when considering use of a practical expedient for valuation when using inputs based on bid and ask prices:

- “The price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value” (FAS 157, paragraph 31);
- “Use of mid-market pricing or other pricing conventions as a practical expedient” is not precluded (FAS 157, paragraph 31); and
- “The use of bid prices for long positions (assets) and ask prices for short positions (liabilities) is permitted but not required.” (FAS 157, paragraph C91).

Given these alternatives, on the adoption date of FAS 157 reporting entities may want to change their accounting policies with respect to valuations using inputs within a bid-ask spread.

At the time of adoption of FAS 157, we believe that a reporting entity may change methods to any of the acceptable methods outlined above without obtaining a preferability letter. As part of a reporting entity’s initial adoption of FAS 157, it is appropriate to reconsider all previous fair value-related accounting policy decisions to ensure conformance with the framework provided by FAS 157. A change in policy with respect to inputs based on a bid-ask spread may be included in this overall reconsideration.
However, fair value measurements are accounting estimates and, except as specifically provided in FAS 157, the adoption of the Standard is prospective. Therefore, except for the few instances of limited retrospective application (as further discussed in Chapter 6: Effective Date and Transition below), the adoption of a new convention or manner of measuring fair value as a result of adopting FAS 157 would be treated as a change in estimate and will affect reporting entities’ statements of income in the first period for which the fair value measurement is estimated and recorded.

The method of estimating fair value should generally be applied consistently. Use of the mid-market convention is a practical expedient allowed by FAS 157, but its use may result in a measurement that is less precise than the use of bid prices for long positions and ask prices for short positions. Therefore, subsequent to the adoption of FAS 157, it may not be considered supportable for a reporting entity whose accounting policy has not been mid-market pricing, to make that change without a compelling reason for why the change results in an improved measurement.

Note that changes in other inputs or methods of measuring fair value may arise due to a change in market participant assumptions, availability of data and similar items. Paragraph C57 of FAS 157 provides that a change in valuation technique is appropriate if it results in a measurement that is equal to or more representative of fair value in the circumstances.

**Question 4-19: In what circumstances is application of the mid-market pricing convention appropriate?**

**PwC Interpretive Response**

FAS 157 indicates that pricing inputs with bid-ask spreads may be Level 1, 2, or 3 inputs; however, it does not specifically address when it is appropriate to use the mid-market practical expedient. Election of the mid-market practical expedient is presumed appropriate for pricing inputs within a bid-ask spread that falls within Level 1 of the fair value hierarchy (i.e., unadjusted observable quoted prices for identical assets or liabilities). In these cases, a reporting entity does not need to evaluate mid-market pricing against expectations of where it actually would trade within the bid–ask range.

Mid-market pricing may be acceptable for Level 2 and Level 3 inputs under certain facts and circumstances and would have to be evaluated on a case-by-case basis. The mid-market practical expedient is appropriate only for inputs from markets where stand-ready, dealer-based bid-ask pricing exists, and should not be analogized to other circumstances. Generally, the less observable the input, the less probable that it is subject to a bid-ask spread and, therefore, the less likely that use of a mid-market convention would be appropriate. For example, it may not be appropriate to apply a mid-market convention when the bid-ask spread is wide, indicating the inclusion of a pricing element other than transaction costs (e.g., a liquidity reserve).
Question 4-20: Is it appropriate to record a gain or loss at the inception of the contract as a result of the use of a mid-market pricing convention?

PwC Interpretive Response
FAS 157 permits the use of a mid-point pricing convention as a practical expedient. Whether it is appropriate to record a gain or loss at the inception of the contract as a result of the use of this convention will depend on the facts. For example, assume a company enters into a six-month forward contract for the purchase of gas at an actively traded location (the company’s principal market for that type of transaction) and the contract is accounted for at fair value under FAS 133. The bid-ask spread is $1 (bid: $99; ask: $100). Use of the mid-point convention will result in a $0.50 loss at initial recognition assuming the company purchased at the ask price and recorded the contract using the mid-price convention.

In this case, because the contract trades at a liquid point and was entered into in the company’s principal market, the transaction price would be expected to be the same as the exit price. For Level 1 inputs, it is expected that differences between the mid-market pricing and the trade execution prices would be due to transaction costs and should be minimal. Thus, recognition of an initial loss would be appropriate.

However, as further described above, a reporting entity should evaluate significant bid-ask spreads to determine whether the mid-point is truly indicative of the fair value of the contract.

Question 4-21: How should a reporting entity account for transaction costs in a bid-ask spread?

PwC Interpretive Response
While conceptual and/or economic arguments can be made that transaction costs represent a component of the bid-ask spread, we believe that a reporting entity should not bifurcate the bid-ask spread to identify and account for transaction costs within the FAS 157 valuation framework.
Chapter 5: Disclosures
Chapter 5: Disclosures

FAS 157’s disclosure requirements are intended to provide information about:

- The extent to which a reporting entity measures assets and liabilities at fair value;
- The valuation techniques used to measure fair value; and
- The effect of fair value measurements on earnings.

FAS 157 requires use of a tabular format to present the required quantitative disclosures. In addition, qualitative disclosures about the valuation techniques used to measure fair value are required in all annual periods.

FAS 157’s disclosure requirements vary depending on whether the asset or liability is measured on a recurring or nonrecurring basis and the classification of the fair value measurement in its entirety within the fair value hierarchy. FAS 157 encourages reporting entities to combine the fair value measurement disclosures with the fair value disclosures required under other accounting standards (e.g., FAS 107), if practicable.

5.1 Disclosures – Recurring Measurements

FAS 157, paragraph 32, outlines specific quantitative and qualitative disclosures required for assets and liabilities measured at fair value on a recurring basis. Information should be presented separately for each major category of assets and liabilities, except for derivative assets and liabilities which may be presented net as a single category. Required disclosures for each interim and annual period include the following:

- Fair value measurements at the reporting date in total;
- Fair value measurements segregated among the appropriate levels within the fair value hierarchy; and
- For fair value measurements using Level 3 inputs, a reconciliation of the beginning and ending balances including total gains and losses (realized and unrealized) for the period.

In addition, in annual periods a reporting entity should disclose the valuation techniques used to measure fair value, including a discussion of any changes in the techniques employed. FAS 157, paragraphs A34 and A35, provide examples of disclosures for assets and liabilities measured at fair value on a recurring basis.

**PwC Observation:** The FASB added the detailed disclosure requirements regarding Level 3 inputs to address constituents’ concerns about the reliability of fair value measurements developed using Level 3 (i.e., unobservable) inputs. These disclosures are intended to provide users with information to assess the quality of reported earnings by segregating the unrealized gains and losses recorded in the income statement that relate to Level 3 inputs.
For public companies, the first interim financial statements after adoption of the Standard (the Quarterly Report on Form 10-Q for the period ending March 31, 2008, for calendar year-end companies) should include the required annual disclosures for recurring fair value measurements subject to FAS 157.

5.2 Disclosures – Nonrecurring Measurements

FAS 157, paragraph 33, specifies disclosures for assets and liabilities measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (e.g., impairment of long-lived assets). The objective of these disclosures is to enable users of the financial statements to assess the inputs used to develop those measurements. The disclosures should be presented separately for each major category of assets and liabilities. As applicable, the following information should be presented for each interim and annual period:

- Fair value measurements recorded during the period and reasons for the measurement;
- Fair value measurements segregated among the appropriate levels within the fair value hierarchy; and
- For measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs.

In addition, in annual periods, a reporting entity should disclose the valuation technique(s) used to measure fair value and any changes in the valuation technique(s) used, from prior periods.

These disclosures should be provided in the first interim period that the assets and liabilities are measured at fair value. FAS 157, paragraph A36, provides an example of disclosure of assets measured at fair value on a nonrecurring basis.

This guide addresses certain overall issues and provides guidance associated with FAS 157 disclosures below. In addition, reporting entities should refer to specific guidance on disclosures related to specific areas impacted by fair value in Chapter 8: Application – Potential Recurring Measurements and Chapter 9: Application – Nonrecurring Measurements.

Question 5-1: Is a reporting entity required to include fair value disclosures that are required to be updated on an annual basis in its interim financial statements during the year of adoption?

PwC Interpretive Response

The transition guidance in FAS 157, paragraph 39, states, in part:

The disclosure requirements of this Statement (paragraphs 32-35), including those disclosures that are required in annual periods only, shall be applied in the first interim period of the fiscal year in which this Statement is initially applied.
We believe the requirements of the Standard should be applied at the time the asset or liability becomes subject to fair value measurement under FAS 157. For example, if a goodwill impairment loss is recorded in the fourth quarter and no triggering event occurs at an earlier date requiring a loss to be measured and recorded, we expect that the measurement and disclosure requirements of FAS 157 for that impairment would first be included in the financial statements/information for the fourth quarter (refer also to Question 9-12). Measurements reported at fair value in prior periods that are not remeasured in the period of adoption are not subject to the disclosure requirements of the Standard until such time that the amounts are remeasured at fair value.

Question 5-2: Are fair value measurements required by FAS 107 subject to the FAS 157 disclosure requirements?

PwC Interpretive Response

FAS 107 requires that reporting entities disclose the fair value of all of their financial instruments whether or not recognized on the statement of financial position. Therefore, while certain financial instruments recorded on the statement of financial position may be recorded at historical cost, or on some other basis other than fair value, a fair value measurement for that financial instrument is still required to be disclosed. FAS 107 is within the scope of FAS 157; therefore, the concepts within FAS 157 apply when performing fair value measurements for disclosure purposes.

FAS 157 amended paragraph 10 of FAS 107 to clarify the disclosures required under FAS 107 and what additional disclosures, if any, are required under FAS 157. The following footnote (3aa) was added:

For financial instruments recognized at fair value in the statement of financial position, the disclosure requirements of FASB Statement No. 157, *Fair Value Measurements*, also apply.

FAS 107, paragraph 10, requires that reporting entities disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. However, the additional disclosures required by FAS 157 paragraphs 32 and 33 (e.g., the tabular disclosures) are not applicable unless the financial instrument is recorded at fair value in the statement of financial position.
Chapter 6: Effective Date and Transition
Chapter 6: Effective Date and Transition

6.1 Effective Date

FAS 157 is effective as of the beginning of a reporting entity's fiscal year that begins after November 15, 2007, except for items potentially deferred that are described below. For reporting entities with a calendar year-end, initial adoption of the Standard will occur as of January 1, 2008. The Standard is also effective for interim periods within those fiscal years (i.e., the first quarter of 2008 (or 2009 for potentially deferred items) for a calendar year-end company). Early adoption is encouraged; however, it is permitted only if the reporting entity has not yet issued financial statements for the fiscal year, including an interim period for that fiscal year.

6.1.1 Proposed Deferral

In November 2007, the FASB voted to propose an FSP that would defer the effective date of FAS 157 for one year for nonfinancial assets and nonfinancial liabilities that are recognized and disclosed at fair value in the financial statements on a nonrecurring basis. The deferral was in response to feedback from constituents on the many implementation challenges in applying FAS 157 to nonfinancial assets and nonfinancial liabilities. The proposed deferral will not defer recognition and disclosure requirements for financial assets and liabilities or for nonfinancial assets and liabilities that are remeasured and reported at fair value at least annually.

The following are examples of items that would be subject to the deferral if the proposed FSP is approved:

- Nonfinancial assets and nonfinancial liabilities that are measured at fair value in a business combination or other new basis event, except those that are remeasured at fair value in subsequent periods;
- Reporting units measured at fair value in step 1 of the goodwill impairment test under FAS 142, and nonfinancial assets and nonfinancial liabilities measured at fair value in step 2 of that test;
- Indefinite-lived intangible assets measured at fair value for impairment assessment under FAS 142;
- Asset retirement obligations measured at fair value upon initial recognition under FAS 143, or upon a remeasurement event;
- Assets measured for impairment under FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144); and
- Liabilities for exit or disposal activities measured at fair value upon initial recognition under FASB Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities (FAS 146).
PwC Observation: A one-year deferral would provide reporting entities with additional time to understand and address implementation issues related to nonfinancial assets and nonfinancial liabilities that are measured on a nonrecurring basis. While the proposed FSP will be subject to a 30-day comment period and final approval by the FASB, we expect that the Board will approve the partial deferral consistent with the discussion above. We also expect the proposed FSP to (1) include recommendations on how reporting entities should disclose their method of adopting FAS 157 and (2) specify that the partial deferral does not preclude entities from adopting the entire Standard early.

Notwithstanding the proposed deferral, reporting entities should continue to resolve their implementation issues surrounding the deferred items, to monitor standard-setting activity in this area, and to consider future PwC updates.

6.2 Transition Provisions

FAS 157 is to be applied prospectively as of the first interim period for the fiscal year in which it is initially adopted, except for limited retrospective adoption for the following three items:

- The valuation of financial instruments using blockage factors;
- Financial instruments that were measured at fair value using the transaction price (as indicated in EITF Issue 02-3); and
- The valuation of hybrid financial instruments that were measured at fair value using the transaction price (as indicated in FAS 155).

The impact of adoption in these areas will be applied as a cumulative-effect adjustment to opening retained earnings, measured as the difference between the carrying amounts and the fair values of relevant assets and liabilities at the date of adoption.

PwC Observation: The FASB describes the above transition approach for the three items as a "limited form of retrospective application." The FASB decided to permit this "limited" retrospective approach to allow some relief for reporting entities considering the practical limitations involved in applying the change in method to all prior periods.

6.2.1 Blockage Factors

Prior to the adoption of FAS 157, reporting entities within the scope of the AICPA Audit and Accounting Guides for broker-dealers and investment companies applied blockage factors to the valuation of financial assets and liabilities traded in active markets, in accordance with existing GAAP. However, FAS 157 removes the ability to apply blockage factors for Level 1 measurements. Therefore, those reporting entities will be required to remeasure all financial instruments that trade in active markets that were previously valued using a blockage factor. The difference between the carrying value prior to adoption of FAS 157 and the fair value of those balances...
calculated without a blockage factor must be recorded upon initial application of FAS 157 as a cumulative effect adjustment to opening retained earnings.

In discussing the transition for blockage factors, FAS 157, paragraph 37(a) clearly references financial instruments. As such, we believe that transition guidance applies only to the valuation of financial instruments that trade in active markets and that previously included blockage factors pursuant to the AICPA guides for broker-dealers and investment companies.

6.2.2 Day One Gains and Losses under EITF 02-3

Footnote 3 of EITF 02-3 prohibited immediate recognition of unrealized gains and losses on derivative contracts for the difference between transaction price and fair value, when the fair value determination relied significantly on inputs that are not based on observable market data. However, under FAS 157, the use of unobservable data to measure fair value (when observable data is not otherwise available) and the immediate recognition of Day One gains and losses on derivative contracts is permitted, and footnote 3 of EITF 02-3 has been nullified by FAS 157. To the extent a reporting entity has previously deferred Day One gains or losses on its derivative contracts or other financial instruments in accordance with the guidance of EITF 02-3, it should record an adjustment to opening retained earnings for the difference between the fair value as measured using the principles in FAS 157 and the carrying value of those derivative instruments on the day of adoption.

PwC Observation: Paragraph 37(b) of FAS 157 discusses the limited retrospective transition requirements for “financial instruments” measured under EITF 02-3. While that paragraph refers only to a “financial instrument,” EITF 02-3 applies more broadly and includes derivative instruments, which may not be financial instruments. Therefore, a question arises as to whether the transition provisions are limited solely to financial instruments.

Paragraph C108 of FAS 157 clarifies the transition guidance as follows, “...the difference between the carrying amount and the fair value of a derivative (or other instrument) that was measured at initial recognition using the transaction price in accordance with the guidance in footnote 3 of Issue 02-3 prior to initial application of this Statement should be recognized as a cumulative-effect adjustment....”

Accordingly, we believe that the limited retrospective transition requirements outlined in paragraph 37(b) apply to all instruments within the scope of EITF 02-3, not just financial instruments.

Question 6-1: How should a reporting entity determine the amount of deferred Day One gains and losses to be included in the cumulative effect adjustment on adoption of FAS 157?

PwC Interpretive Response
While reporting entities may have deferred certain Day One gains and losses pertaining to derivative or other contracts, the recognition of those amounts in the cumulative effect adjustment immediately upon adoption of FAS 157 may
not always be appropriate. A reporting entity evaluating its Day One deferrals at adoption of FAS 157 should be able to demonstrate that immediate recognition is appropriate. This includes ensuring that any valuation model used correctly calculates a fair value that is consistent with the exit price definition of fair value in FAS 157, based on a full evaluation of market conditions existing at the time of the transaction.

A reporting entity should also consider the nature of its deferrals, which may have arisen due to credit, model, or other types of adjustments included in its previous valuations. To the extent these types of deferrals continue to be necessary to adjust the model price to an appropriate exit price, the amounts should not be included in the cumulative-effect adjustment to opening retained earnings. These model adjustments would be recorded in the statement of income in subsequent periods as part of the overall changes in fair value as measured using FAS 157.

6.2.3 Hybrid Financial Instruments

If a reporting entity recorded a hybrid financial instrument (e.g., a call or put option embedded in a debt instrument) and measured it at fair value using transaction price in accordance with FAS 133 and FAS 155, it is required to begin using an exit price upon adoption of FAS 157. The difference between the carrying value of any such instruments recorded as of the FAS 157 adoption date and the fair value based on an exit price must be recorded as a cumulative-effect adjustment to opening retained earnings.

6.3 Disclosure Considerations

Periodic filings that a public company makes prior to the adoption of FAS 157 must comply with the requirements of SAB No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (SAB 74). For example, unless the impact on its financial position and results of operations is not expected to be material, a calendar year-end public company will need to disclose the potential impact of adopting FAS 157 in its 2007 Annual Report on Form 10-K.
Chapter 7: Fair Value Option
Chapter 7: Fair Value Option

FAS 155, FAS 156 and FAS 159 provide reporting entities with an option to measure many financial instruments, selected hybrid financial instruments, and separately recognized servicing assets and servicing liabilities at fair value. The fair value options provided by these standards considerably expands the ability of a reporting entity to select the basis of measurement for certain assets and liabilities.

The key implications of the FVO standards include the following:

- FAS 155 provides the FVO for certain hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation under the requirements of FAS 133.
- FAS 156 permits a reporting entity to choose between the amortization method and the fair value measurement method for each class of separately recognized servicing assets and servicing liabilities.
- FAS 159 provides a measurement basis election for most financial instruments (i.e., either historical cost or fair value), allowing reporting entities to mitigate potential mismatches that arise under the current mixed measurement attribute model. For example, potential differences may arise because certain financial assets are required to be measured at fair value but the related financial liabilities are required to be measured at amortized historical cost.

In addition, both FAS 156 and FAS 159 allow entities to offset changes in the fair values of a derivative instrument and the related hedged item by selecting the FVO for the hedged item. This means entities can avoid application of the complex hedge accounting provisions of FAS 133.

In accordance with the requirements of FAS 155, FAS 156 and FAS 159, once the FVO election is made it is irrevocable. Because the FVO is not a requirement, adoption of the option may result in reduced comparability of financial reporting, both among similar reporting entities and within a single entity, because similar assets or liabilities could be reported under different measurement attributes (i.e., some at historical cost and some at fair value). However, the disclosure provisions of the standards are intended to mitigate this issue by requiring (1) identification of instruments for which the option is elected and (2) extensive information about the effects on the financial statements.

This chapter discusses the concepts regarding the fair value option. In addition, see discussion of application of the fair value option to specific areas in Chapter 8: Application – Potential Recurring Measurements.
7.1 FAS 159 – Scope

FAS 159, paragraph 7, states:

All entities may elect the fair value option for the following items (eligible items):

a. A recognized financial asset and financial liability, except any listed in paragraph 8

b. A firm commitment that would otherwise not be recognized at inception and that involves only financial instruments (An example is a forward purchase contract for a loan that is not readily convertible to cash. That commitment involves only financial instruments – a loan and cash – and would not otherwise be recognized because it is not a derivative instrument.)

c. A written loan commitment

d. The rights and obligations under an insurance contract that is not a financial instrument (because it requires or permits the insurer to provide goods or services rather than a cash settlement) but whose terms permit the insurer to settle by paying a third party to provide those goods or services

e. The rights and obligations under a warranty that is not a financial instrument (because it requires or permits the warrantor to provide goods or services rather than a cash settlement) but whose terms permit the warrantor to settle by paying a third party to provide those goods or services

f. A host financial instrument resulting from the separation of an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument under paragraph 12 of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, subject to the scope exceptions in paragraph 8. (An example of such a nonfinancial hybrid instrument is an instrument in which the value of the bifurcated embedded derivative is payable in cash, services, or merchandise but the debt host is payable only in cash.)

FAS 159, paragraph 8, excludes certain financial assets and liabilities from the scope as further described in Section 7.1.2, “FAS 159 – Excluded Items,” below.
**PwC Observation:** The fair value option is not available for service contracts. In some cases, an investor’s equity method investment, such as a general partnership interest, may include an explicit or implicit compensation component for providing future services. As a result, a question arises as to whether these investments are eligible for the fair value option. We understand that the SEC staff and FASB staff have indicated that the equity method investment is not eligible for the fair value option if there is a significant service component. Accordingly, a reporting entity that holds this type of investment should carefully evaluate whether the service component is significant to determine whether the investment is eligible for the fair value option.

**Question 7-1:** Upon adoption of FAS 159, may a reporting entity apply the fair value option to derivative contracts for which the normal purchases and normal sales (NPNS) exception has been applied under FAS 133?

**PwC Interpretive Response**

Reporting entities may not apply the fair value option to these contracts upon adoption of FAS 159 because NPNS contracts are not financial instruments and when a reporting entity utilizes the NPNS scope exception under FAS 133, it has effectively elected not to record the particular derivative contract at fair value. Under FAS 159, the fair value option only applies to financial instruments, with certain exceptions that do not include NPNS contracts.

FAS 133, paragraph 10(b), in part, defines normal purchases and normal sales as:

… contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.

Moreover, to qualify for the NPNS exception, it must be probable that such contracts will not settle net and will result in physical delivery. NPNS contracts meet the definition of a derivative and are accounted for as such (i.e., measured at fair value with changes in fair value reported in earnings) unless the conditions in paragraph 10(b) of FAS 133 are met and that scope exception is elected.

Because an NPNS contract provides for the purchase or sale of something other than a financial instrument (e.g., a physical good or commodity), it does not meet the definition of a financial instrument. Thus, the fair value option cannot be applied to NPNS contracts upon adoption of FAS 159.

For contracts entered into after adoption of FAS 159, a reporting entity would record the contracts at fair value each period if the NPNS scope exception under FAS 133 is not elected. Thus, the fair value option would not be necessary as the contracts would be recorded at fair value in accordance with FAS 133.
7.1.2 FAS 159 – Excluded Items

Under FAS 159, paragraph 8, the following items are explicitly excluded from the scope of FAS 159:

- An investment in a subsidiary that the entity is required to consolidate.
- An interest in a variable interest entity that the entity is required to consolidate.
- Employers' and plans' obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits (including health care and life insurance benefits), post employment benefits, employee stock options, and stock purchase plans, and other forms of deferred compensation arrangements.
- Financial assets and liabilities recognized under leases, as defined in FAS 13. (This exception does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease).
- Deposit liabilities, withdrawable on demand, of banks, savings and loan associations, credit unions, and other similar depository institutions.
- Financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including "temporary equity"). An example is a convertible debt security with a non-contingent beneficial conversion feature.

In its next FVO project, the FASB will reconsider whether demand-deposit liabilities of financial institutions should qualify for the FVO. All other excluded items will remain outside the scope of the FVO, because the accounting for these items is already addressed by specific accounting pronouncements, and the FASB concluded that the appropriate time for debating the measurement attribute for such items is during any reconsideration of those specific accounting pronouncements.

PwC Observation: Some insurance and investment contracts include features that permit the insured (or the investor) to withdraw (i.e., "demand") amounts specified in the contract; therefore, a question arises as to whether such contracts are subject to the exclusion applicable to demand deposit liabilities as discussed above. We believe that such contracts are eligible for the FVO because the scope exception described above is limited to demand-deposit liabilities of specified financial institutions. The valuation of such insurance contracts, however, would need to reflect the impact of the right of the insured/investor to withdraw.

7.2 FAS 159 – Application

7.2.1 Accounting Election

FAS 159 permits reporting entities to apply the FVO on an instrument-by-instrument basis. Therefore, a reporting entity can elect the FVO for certain instruments but not others within a group of similar items (e.g., for some available-for-sale securities but not for others). However, if the FVO is not elected for all eligible instruments within a group of similar instruments, the
reporting entity is required to disclose the reasons for its partial election. In addition, the reporting entity must disclose the amounts to which it applied the FVO and the amounts to which it did not apply the FVO within that group. FAS 159, paragraph 12, summarizes exceptions to the instrument-by-instrument election as follows:

a. If multiple advances are made to one borrower pursuant to a single contract (such as a line of credit or construction loan) and the individual advances lose their identity and become part of a larger loan balance, the fair value option shall be applied only to the larger balance and not to each advance individually.

b. If the fair value option is applied to an investment that would otherwise be accounted for under the equity method of accounting, it shall be applied to all of the investor’s financial interests in the same entity (equity and debt, including guarantees) that are eligible items.

c. If the fair value option is applied to an eligible insurance or reinsurance contract, it shall be applied to all claims and obligations under the contract.

d. If the fair value option is elected for an insurance contract (base contract) for which integrated or non-integrated contract features or coverages (some of which are called riders) are issued either concurrently or subsequently, the fair value option also must be applied to those features or coverages. The fair value option cannot be elected for only the nonintegrated contract features or coverages, even though those features and coverages are accounted for separately under AICPA Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts. (footnote omitted)

A financial instrument that represents a single contract may not be further separated into parts for purposes of electing the FVO. However, a loan syndication arrangement may result in multiple loans issued to the same borrower. Under FAS 159, each of those loans is a separate instrument, and the FVO may be elected for some loans but not others.

Loan Commitments

SAB No. 105, Application of Accounting Principles to Loan Commitments (SAB 105), specified that in estimating the fair value of loan commitments that are subject to FAS 133, a reporting entity should exclude from its calculation the expected future cash flows related to the associated servicing of the loan. On November 5, 2007, the SEC staff issued SAB No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings (SAB 109), to provide guidance on the measurement of written loan commitments recorded at fair value. SAB 109 supersedes SAB 105. SAB 109 expresses the SEC staff’s view that, consistent with FAS 156 and FAS 159, the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings.
7.2.2 Timing

FAS 159, paragraphs 25 through 30, provide guidance on its effective date and transition provisions (see further discussion in Section 7.4, “FAS 159 – Effective Date and Transition.”) In accordance with this guidance, for existing assets and liabilities, an entity can elect the FVO only at the date of initial adoption of FAS 159, except in response to a triggering event. Subsequent to initial adoption, in accordance with FAS 159, paragraph 9, in part, an entity can choose to apply the FVO on the date when any one of the following occurs:

a. The entity first recognizes the eligible item.

b. The entity enters into an eligible firm commitment.

c. Financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting.

d. The accounting treatment for an investment in an entity changes.

e. An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or other-than-temporary impairment.

Remeasurement events, as discussed in paragraph 9(e), are described in FAS 159, paragraph 10. Remeasurement events include (1) business combinations as defined in FAS 141; (2) the initial consolidation or deconsolidation of a subsidiary or a variable-interest entity, or the reconsolidation of a deconsolidated variable-interest entity; and (3) significant modifications of debt, as defined in EITF Issue No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments.

PwC Observation: FAS 159 requires reporting entities to make a separate decision about whether to elect the FVO for each eligible item as its election date occurs. Entities may also elect the fair value option based on a pre-existing policy for specified types of eligible items. We believe that the level of documentation of such a policy may vary among reporting entities but that such documentation should be sufficiently clear so that items that are subject to the FVO are easily understood.

7.2.3 Accounting Impact

FAS 159 requires immediate recognition of upfront costs and fees related to items for which the FVO is elected. For example, if the FVO is elected for an insurance contract, a company should not recognize any deferred acquisition costs related to that contract. Similarly, if the FVO is elected for a loan receivable, the entity should not recognize any deferred loan-origination fees or costs related to that loan.

Immediate recognition of previously deferred income and expense items will significantly change both the recognition pattern and the presentation of
income or expense in the income statement. For example, for originated loans that are not measured using the FVO, deferred fees and costs are capitalized as a net basis adjustment and either amortized to interest income or recognized as part of the gain/loss on sale of the loan. However, if an originated loan is measured using the FVO, the costs and fees are recognized in current earnings in the applicable expense or revenue accounts (e.g., salaries, legal fees, fee revenue).

**Interest Income and Expense**

FAS 159 amends APB Opinion No. 21, *Interest on Receivables and Payables* (APB 21), to specify that amortization of premiums and discounts does not apply to items for which the FVO has been elected. Furthermore, FAS 159 states that it does not establish requirements for recognizing and measuring dividend income, interest income, or interest expense but that the reporting entity’s policy for such recognition should be disclosed.

FAS 159 allows for significant policy discretion in how to report interest income and expense for items under the FVO. We believe reporting entities may apply one (or some variation) of the following models for reporting interest income and expense:

- Present the entire change in fair value of the FVO item – including the component related to accrued interest, in a single line item in the income statement.

- Separate the interest income or expense from the full change in fair value of the FVO item and present that amount in interest income/expense with the remainder of the change in fair value presented in a separate line item in the income statement. The allocation to interest income/expense should be an appropriate and acceptable method under GAAP.

Each presentation covers the same net change in fair value of the FVO item but can result in significant differences in individual line items in the income statement. Reporting entities should select a policy for income statement presentation that is appropriate for their individual facts and circumstances, disclose the policy in the notes to financial statements, and follow it consistently.

Any upfront costs and fees related to items measured at fair value upon the adoption of FAS 159 should be removed from the statement of financial position and included in the cumulative-effect of adoption adjustment.

**Other Income Statement Impact**

The SEC staff recently updated its position related to the presentation in the income statement of instruments measured at fair value. The SEC staff currently believes that changes in the fair value of an instrument recognized at fair value each reporting period should be presented on a single line on the income statement, with certain exceptions (i.e., different components of the change in fair value should not be presented separately). The only exceptions to this single line item presentation are when other specific GAAP permits a different (i.e., separated) presentation.
Examples of exceptions include derivatives that have been designated in qualifying hedging relationships; certain investments in debt and equity securities; certain originated or acquired loans; and, certain indebtedness. The change in fair value of these instruments may be presented in other than a single line presentation pursuant to the GAAP applicable to the instruments.

### 7.3 FAS 159 – Disclosure Requirements

Due to the potential for reduced comparability of financial reporting, one of the Board’s objectives in prescribing the required disclosures is to ensure that the reader of a reporting entity’s financial statements will understand the extent to which the FVO is being used and how changes in fair values affect earnings for the period.

FAS 159 permits entities to apply the FVO on an instrument-by-instrument basis; however, it requires additional disclosures if the FVO is elected for only some of the eligible items within a group of similar eligible items (e.g., a description of those similar items and reasons for partial election).

Appendix B of FAS 159 includes an example of a disclosure that integrates FAS 159's disclosure requirements with the requirements in both FAS 157 and FAS 107. The example is for illustrative purposes only and does not present the only method to comply with the disclosure requirements.

### 7.4 FAS 159 – Effective Date and Transition

FAS 159 is effective as of the beginning of a reporting entity’s fiscal year that begins after November 15, 2007. For reporting entities with a calendar year-end, initial adoption of FAS 159 will occur as of January 1, 2008. The effect of adoption should be reported as a cumulative-effect adjustment to the opening balance of retained earnings.

Periodic filings made by a public entity prior to adoption of FAS 159 should follow the guidance in SAB 74. For example, unless the impact on its financial position and results of operations is not expected to be material, a calendar year-end public company will need to disclose the potential impact of adopting FAS 159 in its 2007 Annual Report on Form 10-K.

### 7.5 FAS 159 – Transition Issues

The SEC staff has expressed concern about a strategy under which a reporting entity applies the transition provisions of FAS 159 that allow unrecognized losses to be taken directly to retained earnings, when it does not intend to apply FAS 159’s fair value provisions to similar financial instruments going forward. The SEC staff focused on whether the reporting entity is adopting the fair value option with the objective of mitigating volatility in reported earnings caused by differences in the measurement of related assets and liabilities, which is one of the objectives of FAS 159. In the absence of an intention on the part of the reporting entity to meet this objective, the SEC staff will question whether there has been a substantive adoption of FAS 159.
On April 17, 2007, the AICPA’s Center for Audit Quality, in conjunction with discussions with the SEC staff, the FASB staff, and the public company audit firms that are members of the CAQ, released CAQ Alert 2007-14, *FAS 159 Early Adoption Date Approaching – Factors to Consider*, which provides further guidance on these transition issues. The first example below, which was cited by the CAQ, and the two additional examples thereafter describe situations that could raise questions about whether adoption of FAS 159 is substantive:

- **Available-for-Sale Securities**
  A company adopts FAS 159 by electing the fair value option for certain eligible underwater available-for-sale securities. The corresponding unrealized losses are recorded as a cumulative-effect adjustment to beginning retained earnings.Shortly thereafter, the company disposes of those investment securities and does not elect the fair value option for any of its financial instruments going forward. In a more egregious scenario, the company then uses the proceeds to purchase similar but higher yielding investment securities, and does not elect the fair value option for those newly purchased investment securities. In both scenarios, the company avoids recording unrealized losses in its income statement, but does not adopt fair value reporting in any meaningful way.

- **Issuer of Debt Obligations**
  A company adopts FAS 159 by electing the fair value option for certain eligible issued debt obligations for which it has unamortized debt issuance costs. Upon adoption, the remaining issuance costs are recorded as a cumulative-effect adjustment to beginning retained earnings. Shortly thereafter, the company repays this debt obligation. Another scenario may entail the company’s refinancing its debt obligation, satisfying debt extinguishment requirements, and not electing the fair value option for the newly issued debt obligations. The company avoids recording the prior issuance costs or loss on extinguishment in its income statement.

- **Loans and Lower-of-Cost-or-Market (LOCOM) Adjustments**
  A company has a portfolio of loans that are classified as loans held for sale. Although an individual loan may have a fair value that is either less than or greater than the loan’s cost basis, when assessing the portfolio on an aggregate basis, no adjustment to reduce the cost basis of the loans in the portfolio to fair value, is recorded. The company adopts FAS 159 for only those loans that have a fair value less than the cost basis. The corresponding losses are recorded as a cumulative-effect adjustment to beginning retained earnings. Upon sale of the loans, the company does not recognize a gain or loss for the loans for which the fair value option was elected and recognizes gains for its other loans. Subsequent to the initial election, the company does not elect the fair value option for any other loans within its portfolio.
Accounting Considerations

Absent other considerations that may evolve from practice, the totality of the actions in any one of the examples described above may indicate that going forward the company has little or no intent to utilize the fair value option as a measurement attribute with respect to those classes of financial assets or liabilities, and hence the company has not substantively elected the FVO for those classes of financial assets or liabilities upon adopting FAS 159.

In other situations, the answer may be less clear, requiring entities to use judgment – based on the specific facts and circumstances – as to whether the adoption of fair value in transition represents a substantive adoption of FAS 159. For example, even if a company continues to apply the fair value measurement option for a class of transactions for which a transition loss was taken through retained earnings, the SEC staff may question situations in which the dollar amount of the transactions related to that loss is larger than the dollar amount of the transactions expected to be fair valued on a recurring basis subsequent to transition.

If a reporting entity is considering adopting FAS 159 for a liability resulting from an existing transaction or a class of transactions that it deems to be different from other transactions or classes of transactions and not expected to recur, the reporting entity should be able to articulate both its rationale for adopting fair value in the context of FAS 159 objectives and the support for its conclusion that the transaction or class of transactions are different from others that are not being recognized at fair value going forward.

In situations where adoption of FAS 159 is deemed appropriate, and where unrealized losses are being recorded directly in retained earnings in connection with the adoption of FAS 159, we recommend that reporting entities provide clear and transparent disclosures of the reasons for electing the fair value option for specific eligible items and for not electing the fair value option for other eligible items within a group of similar items, including a discussion of any accounting motivations of such elections.
Chapter 8: Application — Potential Recurring Measurements
8.1 Investments and Other Financial Instruments

Investments and other financial instruments, such as mortgage loans, may be recorded on the balance sheet based on a number of different models. For financial instruments reported at fair value, management may need to change certain valuation policies and procedures in order to comply with FAS 157.

Key concepts that should be considered when applying FAS 157 to investments and other financial instruments include the following:

Figure 8-1
Impact of FAS 157 on Investments

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction costs – costs to sell</td>
<td>Costs to sell are generally not included.</td>
</tr>
<tr>
<td>Fair value is reduced by brokerage commissions and other costs normally</td>
<td></td>
</tr>
<tr>
<td>incurred in a sale.</td>
<td></td>
</tr>
<tr>
<td>Key accounting considerations – all investments</td>
<td></td>
</tr>
<tr>
<td>Fair value determined based on guidance in specific standards applicable to</td>
<td>• Change in definition of fair value</td>
</tr>
<tr>
<td>the instruments.</td>
<td>• No reliability threshold – requires that fair value be estimated based</td>
</tr>
<tr>
<td></td>
<td>on an appropriate model or other estimation technique when observable</td>
</tr>
<tr>
<td></td>
<td>data is not available.</td>
</tr>
<tr>
<td>Mortgage loans held for sale (FAS 65)</td>
<td>Amends the basis for recording mortgage loans held for sale from LOCOM</td>
</tr>
<tr>
<td>Recorded at lower of cost or market.</td>
<td>to lower-of-cost-or-fair-value.</td>
</tr>
<tr>
<td>Loans receivable (FAS 114)</td>
<td>maintains practical expedient allowing use of contract or collateral fair</td>
</tr>
<tr>
<td>Measurement of loan impairment based on lower of cost or present value; as</td>
<td>value; requires application of FAS 157 when used.</td>
</tr>
<tr>
<td>a practical expedient may use fair value of the contract or collateral if</td>
<td></td>
</tr>
<tr>
<td>loan is collateral dependent.</td>
<td></td>
</tr>
</tbody>
</table>

*continued*
Prior Practice | FAS 157
---|---
**Investments in debt and equity securities (FAS 115 and FAS 124)**<br>• Securities reported at fair value typically based on prices in active markets or other observable data.<br>• No consideration of restriction on securities if less than one year.<br>• The definition of “readily determinable fair value” for purposes of determining equity securities in the scope of FAS 115 and FAS 124 were not amended by FAS 157.<br>• Restrictions of less than one year must now be factored into measurement of fair value.<br>**Real estate and other investments**<br>No consistent framework when reported at fair value; determination of fair value depended on accounting policy and the presence of observable data.<br>Establishes framework for valuing these investments.<br>**Key valuation considerations – investments recorded at fair value**<br>• Market prices should be used, if an active market exists for the investment.<br>• Prices for similar investments may be helpful in estimating fair value.<br>• If market prices are unavailable, expected cash flows may be considered, discounted at a risk-adjusted rate.<br>• Income, cost, or market valuation technique(s) should be used as appropriate.<br>• Requires consideration of principal and most advantageous market; determination of market participants may impact conclusions.<br>• Requires use of market participant assumptions and a determination of highest and best use.<br>**Key changes in valuation**<br>• Blockage factors permitted in accordance with certain industry guidance.<br>• No recognition of blockage factors for financial instruments for which prices in active markets are available (see Section 4.5.1.3).<br>• Change in requirements related to restricted securities (see Section 4.1.5.1).<br>• Policy related to bid-ask spread pricing convention (see Section 4.5.4).
8.1.1 Mortgage Loans Held for Sale

Mortgage loans held for sale represent a mortgage banker’s “inventory” of products. Prior to FAS 157, FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (FAS 65), paragraph 4, stated that mortgage loans held for sale shall be reported at LOCOM. FAS 157 amends the definition of “market” in applying FAS 65 to become the lower of cost or fair value, determined as of the balance sheet date. The excess of cost over fair value is required to be accounted for as a valuation allowance, with changes in the valuation allowance included in earnings in the period in which the change occurs.

FAS 65, paragraph 9, requires that the fair value of mortgage loans held for sale be determined by type of loan. At a minimum, a reporting entity should make separate determinations of fair value for residential and commercial mortgage loans. Either the aggregate or individual loan basis may be used in determining the lower of cost or fair value for each type of loan. However, the analysis should be consistent with the way the underlying loans are valued and ultimately sold by the reporting entity. A reporting entity’s policy will establish the unit of account to be used in making the FAS 157 measurement of fair value.

8.1.1.1 Mortgage Loans Held for Sale – Disclosure Requirements

Mortgage loans recorded at the lower of cost or fair value represent a nonrecurring measurement for purposes of applying FAS 157. A loan becomes subject to the measurement requirements of FAS 157 when, and if, it is marked down to its fair value. Mortgage loans recorded at fair value must comply with the disclosure requirements for nonrecurring measurements set out in paragraph 33 of FAS 157.

8.1.1.2 Mortgage Loans Held for Sale – Fair Value Option

Many financial institutions who early adopted FAS 157 and FAS 159 have elected the fair value option for their mortgage loans held in the pipeline awaiting sale or securitization. This election obviates the need for complex hedging strategies and allows for consistent fair value treatment of the loans and the related derivatives used to economically hedge the risks of holding the loans. When the fair value option has been invoked, fair value measurements are recurring and subject to the measurement requirements of FAS 157 and the disclosure requirements for recurring measurements in accordance with paragraph 32 of the Standard.
8.1.2 Loans

A creditor holding loans that are not debt securities will use one of three models when reporting the loans on its balance sheet:

- Lower of cost or fair value for loans held for sale;
- Cost less an allowance for credit losses for loans held for investment; or
- Fair value for loans for which the option under FAS 159 has been elected.

The use of the fair value option is discussed in Chapter 7: Fair Value Option. Loans reported at lower of cost or fair value are treated in the same manner as mortgage loans held for sale as discussed in Section 8.1.1, “Mortgage Loans Held for Sale,” above. Loans carried at cost less an allowance for credit losses may be subject to the measurement provisions under FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan – an amendment of FASB Statements No. 5 and 15 (FAS 114) as further discussed below.

Creditors recording loans held for investment initially report the loans at their historical cost. If a loan is identified to be evaluated for collectibility, FAS 114 generally provides that the holder record the loan based on its expected future cash flows discounted at the loan’s effective rate. The initial recording of the loan at cost and the recording of impairments based on a loan’s effective rate are not fair value measurements. However, FAS 114 also allows a practical expedient to estimate the impairment of a loan using either the observable market price (i.e., fair value) of a loan or the fair value of the underlying collateral if the loan is collateral dependent. Regardless, a creditor must measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable.

The measurement framework of FAS 157 applies when fair value is used to determine the carrying amount of impaired loans. As a result, impaired loans measured using the practical expedient and collateral dependent loans for which foreclosure is probable are reported at fair value on a nonrecurring basis both at initial recognition of impairment and on an ongoing basis until recovery or charge-off. Accordingly, in those circumstances the disclosure provisions in paragraph 33 of FAS 157 for nonrecurring fair value measurements will apply.

A creditor shall continue to consider estimated costs to sell (transaction costs), on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan.

8.1.3 Investments in Marketable Equity and Debt Securities

The scope of FAS 115 includes investments in equity securities that have readily determinable fair values and all investments in debt securities. FAS 115 provides three models that may be applied in the initial recording and subsequent adjustment of these securities. An equity security that has a “readily determinable fair value” as defined by FAS 115 must be recorded at fair value as either a “trading security” or a security that is “available-for-sale.” Debt securities may also be recorded at fair value as either trading or available-for-sale securities; however, under certain conditions, FAS 115 also permits a third option, “held-to-maturity,” under which debt securities are
recorded at amortized cost. Securities recorded at fair value and treated as either trading or available-for-sale are subject to the measurement requirements of FAS 157 and the disclosure requirements for recurring measurements in accordance with paragraph 32 of the Standard. Securities reported as held-to-maturity are not within the scope of the disclosure requirements of FAS 157. The fair values of held-to-maturity securities are required to be measured consistent with the provisions of FAS 157 when preparing the disclosures required by FAS 115 for fair value amounts and unrealized gains and losses.

8.1.3.1 Restricted Securities

If a reporting entity holds a security that has restrictions on its sale or transferability (i.e., a restricted security), the fair value measurement should be adjusted to reflect the discount a market participant would require as a result of the holding period. That general principle applies regardless of when the restriction ends. As a result of the definition and valuation of restricted securities under FAS 157, previous practice under FAS 115 for securities with sale restrictions of less than one year may change.

Example 8 of FAS 157 illustrates the impact of a legal restriction on the sale of a security under SEC Rule 144. It notes that the "restriction is specific to (an attribute of) the security and, therefore, would transfer to market participants." Accordingly, the restriction should be considered in the valuation of the security since the restriction would be considered by market participants when determining the fair value of the security. However, if the restriction arises outside of the security, it would not be included in the valuation. This may occur as a result of side agreements or compliance with statutory requirements imposed on the holder of the security that are not a direct attribute of the security.

Question 8-1: When should a reporting entity incorporate restrictions on sale when determining fair value?

PwC Interpretive Response

The impact of a restriction on the sale or use of an asset depends on whether the restriction would be considered by market participants in pricing the asset. In determining whether a restriction should be considered in the valuation of a security, the source of the restriction and its connection to the underlying security should be carefully analyzed.

For a restriction to be considered an attribute of the security, the restriction should be specific to the security, not to the reporting entity holding the security. It is not the existence of a condition that determines whether a security is restricted; it is the connection to the security. For example, a company holding a block of stock in another company may also hold a board seat on the investee. Through the board seat, the company obtains material, nonpublic information and as a result cannot sell the security until such information becomes public. Since the board seat is not a specific attribute of the security held, the material nonpublic information and accompanying restriction should not be considered in the valuation of the security. Similarly, holders of securities may at times be subject to blackout periods as a result of possessing material non-public information. In those cases, the restriction is
not attributable to the security, but rather the holder and therefore should not be considered in determining the fair value.

When the restriction is established is not critical to the analysis. Whether the restriction existed on the date the security was acquired or the restriction was created subsequent to acquisition, the holder should consider its impact on the security's fair value at each reporting date if the restriction is specific to the security and would be considered by market participants in determining the exit price.

8.1.3.2 Investments Held by Not-for-Profit Entities

FASB Statement No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations (FAS 124), is applicable for not-for-profit reporting entities and is similar to FAS 115. The key difference from FAS 115 is that all equity securities with readily determinable fair values (as defined by FAS 124) and all debt securities must be recorded at fair value on a recurring basis. Unlike FAS 115, there is no option to record certain investments in debt securities at amortized cost. The same issues with respect to measuring fair value that apply for investment securities under FAS 115 also apply under FAS 124.

8.1.3.3 Investments – Fair Value Option

FAS 159 provides reporting entities with the option to report investments that meet the definition of a financial asset at fair value. See further discussion of eligible securities in Chapter 7: Fair Value Option. If an entity elects the fair value option for an investment, it will be reported at fair value and all changes in fair value will be recorded through the income statement.

For financial reporting purposes, securities under the fair value option are not a separate category. Instead, the presentation will be the same as that followed for trading securities (even if the reporting entity has no short-term intention to sell the securities). If a reporting entity elects the fair value option for one or more investments, it may use terminology such as “securities carried at fair value” in describing these securities, instead of the “trading” terminology in FAS 115. Some reporting entities may be precluded from engaging in security trading activities by law or regulation; these restrictions do not preclude election of the FVO.

Cash Flow Statement Presentation

FAS 159 amends FASB Statement No. 95, Statement of Cash Flows (FAS 95), and FAS 115 to specify that cash flows from trading securities (which include securities for which a reporting entity has elected the FVO) should be classified in the statement of cash flows based on the nature of and purpose for which the securities were acquired. Prior to this amendment, FAS 95 and FAS 115 specified that cash flows from trading securities must be classified as cash flows from operating activities.

Subsequent Disposition

Once the FVO is elected for an asset that was previously a held-to-maturity security, subsequent sales of those securities after the reporting entity has
held them for a sufficient period of time to demonstrate that the fair value election was substantive do not “taint” the remaining held-to-maturity portfolio as these securities are no longer held-to-maturity securities. Similarly, selling a security at a loss that was previously an available-for-sale security for which the fair value option was elected and deemed to be substantive does not raise questions about management’s assertions regarding intent and ability to hold remaining available-for-sale securities until recovery when evaluating an other-than-temporary impairment. However, a reporting entity should be making assertions about intent and ability to hold available-for-sale securities with unrealized losses in the balance sheet prior to adoption even if it plans on adopting the fair value option in the next period. A plan to sell securities or a sale of securities soon after adoption of FAS 159 may call into question prior assertions about intent and ability to sell.

8.1.4 Fund Investments

The following questions and interpretive responses address specific application issues related to the valuation of limited partnership and mutual fund investments:

**Question 8-2: Does use of the reported net asset value of an investment company (fund) represent fair value for an investment in such entity in accordance with FAS 157?**

**PwC Interpretive Response**

The net asset value (NAV) of an open-end fund, whether a registered investment company fund such as a mutual fund or certain alternative investment funds such as a hedge fund, serves as the basis for subscription and redemption transactions for investors in such entity. For investments in funds for which the underlying assets and liabilities are required to be measured at fair value (which is the case under GAAP) and NAV is available, that value is generally the most appropriate starting point when determining the fair value measurement for an interest in such fund.

However, when valuing such an investment, the holder must estimate the fair value of the interest held, which at times may be different from a value based solely on the NAV of the fund. The holder should also consider various factors including, but not limited to, the attributes of the interest held, including any restrictions or illiquidity on the disposition of the interest, and its requirement to understand and accept the valuations provided by the investee fund (or modify them if appropriate), to determine the fair value of the interest itself. Depending on the facts and circumstances, the NAV may need to be adjusted depending upon the rights and obligations of the ownership interest and/or other factors. Furthermore, any adjustments based on unobservable inputs to NAV may result in the fair value measurement being categorized as a Level 3 measurement, if those inputs are significant to the overall fair value measurement.
Open-ended Mutual Funds

An open-ended mutual fund may produce a daily NAV that is validated with a sufficient level of observable activity (purchases and sales at NAV) to support classification of the fair value measurement as Level 1 or Level 2 in the fair value hierarchy. In this case, the holder may determine that NAV represents the exit value of the security at the measurement date.

Alternative Investment Funds

Alternative investment funds are typically not traded on an exchange and the funds do not stand ready to redeem shares on a daily basis. Instead, depending on the nature and structure of the fund, restrictions may apply that may impact the fair value determination.

Because of the restrictions associated with interests in hedge funds, there is generally no secondary market for trading interests in such funds. Instead, the fund’s NAV serves as the basis for the investor's periodic (e.g., monthly or quarterly) subscription and redemption activity pursuant to the terms of the fund’s governing documents. In effect, the NAV serves as both the entry price (for subscriptions) and, depending on the facts and circumstances, the exit price (for redemptions). To the extent that there is an adequate level of observable activity (i.e., subscriptions and redemptions at NAV) to support a determination that the NAV represents an exit value of the security at the measurement date, such activity may support classification of the fair value measurement as Level 2 or Level 3 in the fair value hierarchy. For various reasons, certain open-end hedge funds may designate a portion of investor’s capital as not eligible for discretionary redemption (so called “side pocket accounts” or “designated accounts”). The portion of an investor's overall investment allocated to such accounts in an otherwise open-end hedge fund, has characteristics similar to a private equity fund investment and, in certain respects, should be evaluated as such for purposes of fair value measurements.

Private Equity Funds

Closed end funds such as most private equity and private real estate funds do not have liquidity to provide for redemptions to investors. Accordingly, investors are "locked-in" and must wait until the fund can sell its investments in order to convert the fair value of the investment into cash which can then be distributed under the terms of the fund’s governing documents. In some situations, a transaction for an interest in a private equity fund may occur in the "secondary market" where an investor purchases a limited partner’s existing interest and remaining commitment in a private equity fund. This often results from the seller’s need for liquidity, inability to fund future commitments or desire to reduce its exposure to private equity. The seller may sell its investment to the buyer at a discount or, for various reasons, at a premium to the fund’s NAV. Consequently, depending on the facts and circumstances, the sale or transfer price between the parties may or may not be indicative of fair value. Public closed end funds, such as real estate investment trusts and closed end mutual funds, generally have active secondary markets for their listed shares which should serve as the basis for their valuation, as opposed to the fund’s NAV.
Question 8-3: Do liquidity restrictions require a discount to NAV when valuing an investment in a fund?

PwC Interpretive Response

The investment that is being valued by a reporting entity is its interest in the fund and not the individual investments within the fund. As such, restrictions and other features attributable to the interest in the fund, rather than the investor, must be considered, along with other factors, in the measurement of fair value. In general, restrictions on the sale of a security that attach to the security, rather than the holder of the security, would result in a discount in valuation relative to an unrestricted security. However, depending on the specific facts and circumstances, including but not limited to, the type of security being valued and its attributes, the discount may not be warranted.

Example 8-1
Impact of Restrictions on Net Asset Value

Consider the implications of the restriction in the following fact pattern:

- A fund investment may be redeemed on the last business day of each calendar quarter subject to a 30-day notice period.
- Pursuant to the terms of the fund's governing documents, the redemption price is NAV as of the close of the effective date of redemption.
- The redemption date and the measurement date are the same.
- There are observable transactions in (i.e., subscriptions) and out (i.e., redemptions) of the fund at its NAV on the redemption date and, historically, on all previous redemption dates. The volume of such activity is sufficient to support a Level 2 pricing input.

In this example, a market participant to which the security would be hypothetically sold (or transferred) would be subject to the restrictions as to its future disposition. As such, the restrictions must be considered in the determination of fair value. However, a reporting entity holding the interest in the fund would also consider the fact that there were observable transactions on the measurement date at the fund’s then current NAV. Entities that subscribed to the fund on the measurement date were subject to the same terms and conditions, including redemption restrictions, as the reporting entity (e.g., limited redemption dates and notice period). In addition, entities redeeming on historical redemption dates did not require a discount to the fund’s NAV as a result of the restrictions, further supporting the absence of consideration of the restrictions on valuation.

In this example, the reporting entity may conclude that the fair value of the interest in the fund is the NAV. In making this conclusion, it may point to observable transactions for identical interests on the reporting date and the absence of any discount for the restrictions, assuming no other features of the interest require individual consideration or would have offset the effect of the restrictions. This may be the case for a number of reasons, including the investor’s expectation of correlation between the fund’s liquidity terms and the

continued
liquidity of the underlying portfolio (i.e., the more liquid the investments in the portfolio, the greater the liquidity generally provided to investors), the presence of similar restrictions in comparable fund investments, which causes the restriction to be customary to the market participant or a desire to invest with a certain fund manager or advisor.

8.2 Servicing Assets and Servicing Liabilities

Servicing is defined as the contractual right to service or administer the functions associated with a financial asset. In accordance with FAS 156, a separate servicing asset or liability should be recognized if a servicing right is contractually separated from the financial asset being serviced through a transfer of the financial asset to a third party that qualifies for sale accounting or the acquisition or assumption of the right to service the financial asset from a third party.

Paragraph 13A of FAS 140, as amended by FAS 156, requires separately recognized servicing assets and liabilities to be measured initially at fair value. A reporting entity may subsequently measure each class of servicing assets and liabilities by use of one of two methods:

- **The amortization method**, which involves the amortization of servicing assets or liabilities over the period of estimated net servicing income or net servicing loss. The amortization method requires subsequent measurement at fair value only when servicing assets are impaired or servicing liabilities are less than the fair value of the servicer’s obligation.

  The amortization method represents a nonrecurring measurement for purposes of applying FAS 157 as under this method servicing assets and liabilities are not remeasured at fair value on a systematic basis. The initial measurement is subject to the measurement framework of FAS 157. Subsequent measurement at fair value, if required by FAS 140, is subject to both the measurement requirements of the Standard and the disclosure requirements for nonrecurring measurements set out in paragraph 33 of FAS 157.

- **The fair value measurement method** involves the measurement of servicing assets or liabilities at fair value at each reporting date. Changes in fair value are reported in income in the period of change.

  This method represents a recurring measurement subject to the measurement framework of FAS 157 and the disclosure requirements for recurring measurements in paragraph 32 of FAS 157.

In addition, paragraph 17 of FAS 140, as amended by FAS 156, provides additional disclosure requirements for servicing assets and liabilities. The fair value disclosure requirements of FAS 140 are subject to the measurement framework of FAS 157.
PwC Observation: Servicing rights become distinct assets or liabilities that require separate accounting at the time they are contractually separated from the underlying financial assets. FAS 156 simplifies the accounting for servicing rights and reduces the volatility that historically resulted from the asymmetric accounting for servicing rights and derivative instruments. That is, servicing rights were accounted for at amortized cost and assessed for impairment under FAS 140, while related derivatives used to economically manage interest rate risk associated with servicing rights may not have qualified for hedge accounting under FAS 133 and were carried at fair value on the balance sheet with changes in fair value recorded in earnings.

FAS 156 enables the fair values of servicing assets and liabilities to be aligned with the fair values of the derivative instruments. Consistent with FAS 140 and FAS 156, reporting entities should continue to consider market participant assumptions when valuing servicing rights. In addition, the fair value of servicing rights may be used by reporting entities as an input to the valuation of whole loans and interest rate locks (after the adoption of SAB 109).

8.3 Derivative Assets and Derivative Liabilities

FAS 157 is expected to have a significant impact on reporting entities that enter into derivative transactions. Derivative assets and liabilities within the scope of FAS 133 are required to be recorded at fair value at inception and on an ongoing basis. Therefore, applying FAS 157’s measurement and disclosure requirements may be complex, depending on the composition of the portfolio and the source of valuation information. In addition, as derivatives are recurring measurements, the FAS 157 measurement and disclosure requirements will apply each reporting period.

Furthermore, prior to adoption of FAS 157, recognition of Day One gains and losses was not permitted if the valuation was based on unobservable inputs. However, as further described in Section 6.2.2, “Day One Gains and Losses under EITF 02-3,” footnote 3 of EITF 02-3 was eliminated by FAS 157. As a result all derivative contracts are required to be recorded at fair value at inception even if the exit price is not based on observable market inputs.

A comparison of key aspects of measuring the fair value of derivatives before and after the adoption of FAS 157 follows:
### Figure 8-2
Impact of FAS 157 on Derivative Assets and Liabilities

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of account to be measured</strong></td>
<td>FAS 133 is generally applied to the transaction or contract, which is defined as the unit of account.</td>
</tr>
<tr>
<td><strong>Definition of fair value</strong></td>
<td>FAS 133, paragraph 540: “The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale…”</td>
</tr>
</tbody>
</table>
| **Measurement of fair value** | - Quoted market prices in active markets are the best evidence of fair value and should be used if available (price times quantity).  
- Valuation techniques should be consistent with the objective of measuring fair value.  
- Suggests valuation techniques including use of the present value of expected future cash flows using discount rates commensurate with the risks involved or various models. | - It is expected that many of the same valuation techniques will be utilized. Prioritization of Level 1 inputs in FAS 133 is consistent with FAS 157.  
- Will require consideration of principal and most advantageous market; determination of market participants may impact conclusions.  
- Requires use of market participant assumptions and a determination of highest and best use.  
- Adjustments may continue to be recorded on a portfolio basis; however, amounts must be allocated to the unit of account for purposes of classification in the fair value hierarchy. |

*continued*
### Prior Practice

**Other considerations – hedge accounting**
- FAS 133 requires assessment of hedge effectiveness at inception of a hedge and on at least a quarterly basis.
- Valuation of liabilities may not have always incorporated adjustments due to changes in credit.

**Other considerations – Day One gains and losses**
Pursuant to footnote 3 of EITF 02-3, Day One gains and losses on derivatives are only recognized if transaction price is different from fair value at inception of the contract, and fair value is based on observable market data.

**Disclosures**
- FAS 107 disclosures about estimation methods; limited transparency as to amounts and classification.

### FAS 157

**Other considerations – hedge accounting**
- Evaluate whether credit adjustments to derivative liabilities are required.
- Credit adjustments may impact the effectiveness and ineffectiveness of hedging relationships, depending on method of hedge effectiveness being used (see Example 8-2).

**Other considerations – Day One gains and losses**
- Day One gains and losses must be recognized if transaction price and exit price are different at inception, even if based on unobservable inputs.
- Models and valuation adjustments should be reviewed to ensure the appropriate computation of fair value.

**Disclosures**
- Enhanced disclosures in accordance with FAS 157 requirements for recurring measurements (see Section 5.1, “Disclosures – Recurring Measurements”).

When estimating the fair value of derivative assets and liabilities, a reporting entity will need to consider the following:

- **Highest and best use:** A reporting entity should assess potential markets, considering the highest and best use of the derivative asset or liability, whether in-use or in-exchange. Generally, derivative instruments will provide the highest fair value in-exchange (see Section 4.1.5, “Valuation of Assets (Valuation Premise”).

- **Principal or most advantageous market:** Depending on the reporting entity’s business, it may or may not have a principal market for its derivative instruments. For example, a financial institution’s principal market for the sale of interest rate swaps may be the retail market, although it may originate in the wholesale market. Conversely, an industrial company entering into an interest rate swap may not have a principal market if it does not transact in volume and does not have access to dealer markets. In either of these circumstances, the reporting entity would need to determine the most likely potential market and to evaluate and determine the characteristics of market participants.
• Determine the valuation technique(s): The reporting entity should consider the income, market, and cost approaches in determining the appropriate method(s) to calculate fair value. We expect that generally the market or income approach will be used when determining the fair value of derivative instruments. Regardless of the technique, market participant assumptions must be incorporated. A reporting entity should consider factors such as incorporating credit and other non-performance risk into derivative valuations, and recording model adjustments for risk if market participants would do so.

• Calculate fair value and allocate to the unit of account if the in-use valuation premise is used. To the extent the valuation premise was not at the same level as the unit of account, the reporting entity will be required to allocate the value back to the unit of account. In addition, to the extent that adjustments or risk margins were determined at a level higher than the unit of account, a reasonable methodology for allocating the adjustments (e.g., relative fair value) will need to be determined for purposes of reporting the unit of account in the fair value disclosures.

FAS 157 requires incorporation of nonperformance risk (including credit risk), into the valuation of assets and liabilities, including those assets and liabilities arising from derivative contracts. A reporting entity’s fair value measurements may change upon adoption of the Standard to the extent that it has not previously considered credit and nonperformance risk in the valuation of its derivative positions, or to the extent that the methodology used to incorporate risk into the valuation is not consistent with the requirements of FAS 157.

The following simple example further illustrates the application of FAS 157 when valuing an interest rate swap by a manufacturing company:

---

**Example 8-2**

**Fair Value Measurement – Cash Flow Hedge**

Company Z wishes to hedge the variability in cash flows associated with its 10-year variable rate debt. It decides to enter into a plain-vanilla, fixed-for-floating interest rate swap for 10 years. Company Z designates the interest rate swap as a cash flow hedge of the interest payments on the debt. Company Z determines the fair value of the interest rate swap and whether it has any special considerations associated with the designated hedging relationship:

<table>
<thead>
<tr>
<th>Determine unit of account</th>
<th>The unit of account is the interest rate swap contract, in accordance with FAS 133.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluate valuation premise</td>
<td>Company Z determines that the highest and best use of the interest rate swap is in-exchange. Based on its assessment, Company Z determines that market participants would not group the swap with other assets.</td>
</tr>
</tbody>
</table>

*continued*
Assess principal market

Company Z determines that it does not have a principal market for the interest rate swap. Its interest rate hedging program has historically included the purchase of swaps, when needed for debt hedging programs, and settlement with the counterparty. It does not trade in swaps or otherwise hold them for speculative purposes.

Determine the most advantageous market

Company Z is aware that there is a retail market and a wholesale market for the type of interest rate swap that it holds. It does not have access to the wholesale swap market. Company Z therefore determines that the retail market is the appropriate market assumption.

Determine valuation technique

Company Z considers the use of each of the valuation techniques as follows:

Market approach – Accommodation quotes are obtained from 2 dealers in the retail swap market. The quotes each indicate a fair value of $9.8 million (liability).

Income approach – Company Z performs a discounted cash flow analysis based on available forward yield curves for plain vanilla swaps of the same type. The analysis concludes that the fair value is $10 million (liability), which includes a discount for nonperformance risk based on Company Z’s credit characteristics.

Cost approach – As the analysis relates to a financial asset, Company Z concludes that the cost approach is not applicable.

Determine fair value

Due to the nature of the swap (i.e., plain vanilla terms for which there are similar swaps that price in active markets), Company Z determines that the market approach provides the best estimate of fair value. Accordingly, Company Z records the interest rate swap at a value of $9.8 million (liability). No allocation is needed as the unit of account and valuation premise are the same.

Hedge considerations

The impact on hedge accounting of applying the concepts of FAS 157 will depend on the method used for measuring hedge ineffectiveness:

- If Company Z is using Method 1 (Change in Variable Cash flows Method) of Derivatives Implementation Group (DIG) Issue G7, Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied (DIG Issue G7), and the terms of the variable leg of the swap and the hedged item match (i.e., variable rate index, interest rate reset dates, no basis differences) credit will impact ineffectiveness only when default is probable.

- If Company Z is using DIG Issue G7, Method 3 (Change in Fair Value Method), credit and nonperformance risk would be considered when determining the fair value of the swap in each period that ineffectiveness is measured.
Company Z may be precluded from using the short-cut method provided by paragraph 68 of FAS 133. If the exit price of the interest rate swap at its inception is different from transaction price, causing the swap's fair value to be other than zero, paragraph 68(b) would not be met and the short-cut method would be precluded. In July 2007, the FASB issued proposed DIG Issue E23, Issues Involving the Application of the Shortcut Method under Paragraph 68 (DIG Issue E23). If finalized in its current form, DIG Issue E23 will amend paragraph 68 of FAS 133 to permit the use of the shortcut method, if the interest rate swap was entered into for a transaction price of zero and its fair value at inception is other than zero solely as a result of the existence of a bid-ask spread in the reporting entity’s principal or most advantageous market for the swap.

The example above is a fairly straightforward demonstration of the steps in calculating the fair value of a standard derivative instrument. Readers should refer to the various questions throughout Chapter 4: Concepts as many of these issues are pertinent to derivatives. In addition, the following questions and interpretive responses address specific derivative-related application issues:

**Question 8-4: Is a reporting entity required (or permitted) to re-evaluate its original determination of bifurcated hybrid contracts?**

**PwC Interpretive Response**

Under FAS 133, if a hybrid instrument has an embedded derivative requiring bifurcation, the embedded derivative is separated from the host contract and accounted for as a derivative. The initial carrying value assigned to the host contract is determined as the difference between the cost basis of the hybrid instrument and the fair value of the embedded derivative. In the absence of stated or implied substantive terms, a reporting entity may need to make its own determination of the hypothetical terms of the host contract and the embedded derivative.

Any change in fair value of the embedded derivative as a result of FAS 157 adoption is considered a change in estimate (assuming the original estimate was in accordance with existing GAAP). A change in estimate of an embedded derivative from one acceptable fair value measurement to the fair value measurement calculated in accordance with FAS 157 does not include the re-determination of the hypothetical terms of the host contract and embedded derivative, as FAS 133 does not permit such a re-determination.
Question 8-5: How does FAS 157 apply to a reported asset or liability that has been designated as the hedged item in a fair value hedge?

PwC Interpretive Response

The asset or liability designated as the hedged item in a fair value hedge is not remeasured at fair value with changes reported in earnings. It may be an item that is reported at fair value with changes in fair value reported in other comprehensive income (e.g., an available-for-sale debt or equity security) or it may be reported based on some other measurement basis. FAS 133 requires that the change in fair value of the hedged item attributable to the risk being hedged be measured over the hedge period and reported as an adjustment of the hedged item’s carrying value. The risk being hedged may be the overall change in fair value or only the change in value attributable to a specific risk.

We believe that in measuring that change in fair value for the hedged item, the fair value estimates used to calculate the change must be measured at their exit values based on the framework for measurement provided by FAS 157. When measuring the basis adjustment for a hedged item that is being hedged for changes in value specific to a particular risk, that change in value should be measured consistently with the way that change in value would be calculated in the overall measurement of the hedged item at exit value under FAS 157.

Application of the disclosure requirements of FAS 157; however, requires a level of judgment. For a hedged item that is otherwise reported at fair value or has been hedged from inception for changes in its overall fair value such that it is essentially measured at its full fair value, we believe it would be appropriate to apply the disclosure requirements of paragraph 32 for recurring measurements. For a hedged item reported on a measurement basis other than fair value, we do not believe the partial measurement of fair value achieved through the adjustments of carrying value require the reporting entity to provide the required disclosures of FAS 157 for the hedged item as a whole or for the adjustments to the carrying value separately. However, to provide transparency and consistent disclosure for all significant measurements that involve fair value, management should consider providing some or all of the FAS 157 disclosures for recurring measurements, for significant partial measurements.

8.4 Margin Deposits and Collateral

As a result of adoption of FSP FIN 39-1, Amendment of FASB Interpretation No. 39 (FSP FIN 39-1), a reporting entity may elect to report certain derivative assets and liabilities subject to a master netting arrangement on either a gross or net basis on the balance sheet. If a reporting entity elects net presentation, it is also required to net related collateral amounts, to the extent such amounts are reported at fair value. Adoption of FSP FIN 39-1 is required as of January 1, 2008 for calendar year-end reporting entities.

The measurement and disclosure of any cash collateral presented at fair value is subject to FAS 157. In accordance with FAS 157, each fair value measurement is classified and disclosed in its entirety within one of three levels in the fair value hierarchy in a tabular format. The amounts in each level for each type of asset and liability within the fair value table should total the related amount recognized on the balance sheet (e.g., the total of amounts in
Levels 1, 2, and 3 for derivative assets should equal the balance of derivative assets on the balance sheet).

To the extent that a reporting entity has elected gross presentation and derivative assets, derivative liabilities, and collateral amounts are presented separately on the balance sheet, it would be appropriate to also include these amounts separately in the reporting entity’s FAS 157 tabular disclosures. Cash collateral balances recorded at fair value should be disclosed within the appropriate levels of the fair value hierarchy.

In determining the appropriate disclosure of such amounts within the fair value hierarchy, a reporting entity should consider whether the collateral should be separately classified (most likely as Level 2 due to the nature of most collateral balances) or classified as part of the net derivative balance.

Paragraph A2 of FSP FIN 39-1 states, in part:

“...The Board believes that when a master netting arrangement exists, offsetting fair value amounts recognized for the receivable or payable recognized upon payment or receipt of cash collateral against fair value amounts recognized for the derivative instruments fairly portrays the amount of credit risk exposure under the entire arrangement.”

In addition, paragraph 15 of FAS 157, states, in part:

“The reporting entity shall consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value. That effect may differ depending on the liability, for example, whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a nonfinancial liability), and the terms of credit enhancements related to the liability, if any.”

In FSP FIN 39-1, the basis for allowing the offset of fair values of receivables and payables against the related fair values of the derivative positions under master netting arrangements is that netting reflects the overall credit exposure under the arrangement. In addition, when valuing derivative liabilities, credit risk and related credit enhancements (e.g., deposits) are considered to be an important part of the fair value of the liability. Therefore, it would be appropriate for a reporting entity that elects a net presentation in the balance sheet to treat the net balance as a single unit of account for purposes of classifying the total balance within the fair value hierarchy.

8.5 Long-term Debt

Long-term debt may be reported at amortized cost or at fair value, if the fair value option provided by FAS 159 is elected. If amortized cost is the basis of reporting, FAS 157 is applicable for purposes of fair value measurements disclosed pursuant to FAS 107. However, a reporting entity electing the fair value option for long-term debt is subject to both the measurement and disclosure requirements of FAS 157.
The key difference when determining the fair value of debt as a result of adopting FAS 157 is that the debt may no longer be valued based on the settlement amount. Instead, the fair value measurement under FAS 157 assumes that the debt will continue to exist (rather than be extinguished). The fair value measurement will be based on what the reporting entity would pay to transfer the obligation to an entity with the same credit standing as its own.

A comparison of key aspects of measuring the fair value of long-term debt before and after the adoption of FAS 157 follows:

**Figure 8-3
Impact of FAS 157 on Long-term Debt**

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key considerations – basis of valuation</strong></td>
<td>The fair value of long-term debt is based on the expectation of it being settled.</td>
</tr>
<tr>
<td><strong>Key considerations – nonperformance risk</strong></td>
<td>Initial interest rate (and related fair value) of long-term debt may consider credit risk; changes in credit or other nonperformance risk is not necessarily incorporated into future fair value measurements.</td>
</tr>
<tr>
<td><strong>Disclosures</strong></td>
<td>FAS 107 disclosures apply.</td>
</tr>
</tbody>
</table>

**8.5.1 Long-term Debt – Valuation Considerations**

For most actively traded debt, there is a rebuttable presumption that material differences do not exist between a settlement value (i.e., purchase in an open market) and a transfer-based fair value measurement. Market participants similar to the issuer should be indifferent between assuming the issuer’s liability and issuing identical debt. However, specific facts and circumstances may support differences in fair value and settlement-based measurements.
The effort required to measure fair value will often be greater with private debt (e.g., private placement or borrowing arrangements entered into directly with a bank). Nonperformance risk (including credit risk) relating to the private debt of the reporting entity must be incorporated into the fair value measurement. When measuring the fair value of private debt, a reporting entity may use prices available for its own existing public debt (or public debt of other similar reporting entities with the same credit standing), with the same key terms, as a starting point. However, any adjustments necessary to take into account market participant assumptions about nonperformance or other risks (such as model risk) are required. Because pricing inputs for nonpublic debt may not be observable, nonpublic debt may often be classified as a Level 3 fair value measurement in the fair value hierarchy.

8.5.2 Long-term Debt – Fair Value Option

FAS 159 provides reporting entities with the option to report long-term debt at fair value instead of on an amortized cost basis. A reporting entity may elect to report its long-term debt at fair value for a number of reasons, including a desire to achieve a natural hedge without having to apply the onerous hedging requirements under FAS 133.

In evaluating the use of the fair value option for long-term debt instead of application of hedge accounting, reporting entities should consider the potential impact on the financial statements as follows:

- Debt issuance costs: When electing the fair value option, all debt issue costs must be expensed immediately, instead of amortized as part of the effective interest rate over the life of the debt. If the election occurs at the time of adoption of FAS 159 all unamortized debt issue costs are recorded as part of the cumulative effect of adoption.

- A full offset of fair value may not occur: When electing the fair value option on the debt, the entire fair value of the debt must be recorded at fair value. In contrast, in the case of a fair value hedge under FAS 133, only that portion of the long-term debt attributable to the risk being hedged (e.g., interest rate risk) must be recorded at fair value. For example, under FAS 133, the changes in fair value attributable to the reporting entity’s changes in credit would be ignored when determining the fair value of the debt that is to be recorded. However, if the reporting entity elects the fair value option, it will be required to reflect the impact of all changes in fair value of its debt (including credit), through the income statement. Because the hedging instrument’s fair value is likely to change due to interest rate changes only, a difference may arise in the statement of income, potentially resulting in volatility.

- Income statement presentation: The SEC staff has previously said that unless a derivative is in a qualifying FAS 133 hedging relationship, all changes in the fair value of the derivative, including changes from interest accruals or net interest cash flows, should be presented in a single line item in the income statement. For qualifying FAS 133 hedging relationships, reporting entities often separate the interest accrual (income or expense) of the derivative from the total change in fair value of the derivative and present the interest accrual component in the same line item as the interest on the hedged item. FAS 159 does not specify income statement...
presentation of changes in fair value related to interest income or expense for which an entity elects the FVO. However, refer to Section 7.2.3, “Accounting Impact,” for discussion regarding current views of the SEC Staff on this matter.

- Irrevocable election: Hedging relationships accounted for under FAS 133 can be de-designated; the fair value option under FAS 159 is irrevocable and the debt will be required to be recorded at fair value throughout its life.

A reporting entity evaluating whether to avail itself of the FVO should weigh the perceived benefits of that action against the implications of adopting other aspects of FAS 159 (e.g., complying with the FAS 159 disclosure requirements).

**PwC Observation:** An entity should consider other implications of applying the FVO to its long-term debt, which would require full mark-to-market as discussed above. For example, recognizing changes in the debt’s fair value in current earnings might adversely impact the entity’s compliance with debt covenants and/or its regulatory and capital requirements. Similarly, debt issuance costs, which are often significant, would be expensed immediately. Further, under the FVO, reporting entities will be required to independently estimate the change in fair value of the debt in accordance with FAS 157. Changes in the fair value of the derivative would not be a proxy for the change in fair value of the debt.

Further guidance related to application of the fair value option is provided in Chapter 7: Fair Value Option.

### 8.6 Pensions and Postemployment Benefit Obligations

#### 8.6.1 Pensions and Other Postretirement Benefit Obligations

FASB Statement No. 87, *Employers’ Accounting for Pensions* (FAS 87), and FASB Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions* (FAS 106), provide guidance on employers’ accounting and reporting for benefit plans, and FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans* (FAS 35), provides guidance for the plan financial statements. In accordance with FAS 87, FAS 106, and FAS 35, plan investments including equity and debt securities, real estate, and other investments, shall be measured at fair value. FAS 157 amends this guidance and generally requires the plan investments to be measured using FAS 157’s definition of fair value. FAS 157 does not apply to the measurement of pension and other postretirement benefit obligations because the liabilities for those obligations are not measured at fair value.

Upon the adoption of FAS 157, the fair value of plan assets must be calculated in accordance with its requirements. Specific considerations and changes from prior practice include the following:
### Figure 8-4
Impact of FAS 157 on Pensions and Postemployment Benefit Plan Assets

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Costs to sell</strong></td>
<td>Fair value is reduced by brokerage commissions and other costs normally incurred in a sale.</td>
</tr>
<tr>
<td><strong>Key valuation considerations – public equity and debt securities</strong></td>
<td>Valuation typically based on price times quantity.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Key valuation considerations – alternative investments</strong></td>
<td>• Market prices should be used, if an active market exists for the investment.</td>
</tr>
<tr>
<td></td>
<td>• Prices for similar investments may be helpful in estimating fair value.</td>
</tr>
<tr>
<td></td>
<td>• If market prices are unavailable, expected cash flows may be considered, discounted at a risk-adjusted rate.</td>
</tr>
<tr>
<td><strong>Disclosures</strong></td>
<td>Certain disclosures required for plan assets, but no specific requirements regarding the measurement of fair value.</td>
</tr>
</tbody>
</table>
In evaluating the impact of FAS 157 on plan assets, a reporting entity should consider the following guidance:

**Publicly-traded Equity and Debt Securities**

The valuation of plan investments in publicly-traded equity and debt securities is not expected to change substantially as a result of adoption of FAS 157, as those investments were typically valued using a price times quantity methodology (consistent with the use of Level 1 inputs under FAS 157). However, in valuing these securities, a reporting entity should ensure that it appropriately adopts the requirements of FAS 157, including consideration of the following:

- **Bid-Ask Spread:** As noted in Section 4.5.4, “Inputs Based on Bid and Ask Prices,” a reporting entity will have to establish a consistent policy for measuring the fair value of plan assets based on a bid-ask spread.

- **Blockage factor:** FAS 157 precludes the application of a blockage factor in valuing financial instruments traded in active markets. See Section 4.5.1, “Level 1 Inputs,” and Question 4-17 for further discussion.

**Real Estate and Other Investments**

Prior to adoption of FAS 157, FAS 87 and FAS 106 stated that the fair value of an investment should be determined based on market prices, if available, or may be estimated based on market prices for similar securities or a forecast of expected cash flows discounted at a risk-adjusted rate. Fair value will now be calculated in accordance with the requirements of FAS 157.

The requirement to revise the valuation methodologies to follow the FAS 157 framework may result in changes in fair value measurements compared to amounts recognized in prior periods. Some employers may need to reconsider their estimates of fair value in cases where illiquid investments such as real estate, are a significant component of plan assets. See additional discussion of specific considerations related to valuations prepared using unobservable inputs in Section 4.5.3, “Level 3 Inputs.”

**Transaction Costs**

FAS 157 states that the fair value of an asset or liability generally should not be adjusted for transaction costs; however, FAS 157 also states that transaction costs should be accounted for in accordance with the provisions of other accounting pronouncements. FAS 157 retains the requirements in FAS 35, 87, and 106 that the fair value of plan assets be reduced by brokerage commissions and other costs normally incurred in a sale, if those costs are significant. Therefore, employers and plan sponsors should continue to reduce the fair value of plan assets by such “selling costs” if those costs are significant. We expect that the implementation of FAS 157 will bring greater attention to this requirement.
8.6.2 Postemployment Benefits

We believe that employers who provide postemployment benefits accounted for under FASB Statement No. 112, *Employers’ Accounting for Postemployment Benefits – an amendment of FASB Statements No. 5 and 43* (FAS 112), and have set aside assets to fund the FAS 112 liability, should apply FAS 157’s fair value measurement principles if those assets are required to be measured at fair value under other applicable GAAP. This would be the case if the assets are subject to the fair value measurement requirements of FAS 115 or if the employer follows the guidance in FAS 87 and FAS 106 when applying FAS 112 and therefore treats the assets as plan assets that are required to be reported at fair value under those standards.

Other considerations related to the impact of FAS 157 on benefit plans include the following:

**Question 8-6: How does FAS 157 apply to employers that report certain investments in insurance contracts held by pension and postretirement benefit plans?**

**PwC Interpretive Response**

FAS 87, paragraph 62, addresses the fair value of investment contracts with insurance companies as follows:

> Insurance contracts that are in substance equivalent to the purchase of annuities shall be accounted for as such. Other contracts with insurance companies shall be accounted for as investments and measured at fair value. For some contracts, the best available evidence of fair value may be contract value. If a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

In accordance with this guidance, certain contracts with insurance companies that are held by pension plans should be accounted for at fair value. FAS 157 preserves practicability exceptions to fair value measurements provided by other applicable GAAP. The guidance in paragraph 62 of FAS 87 allows a reporting entity, as a practical expedient, to use cash surrender value or conversion value as an expedient for fair value when it is present. When measuring the fair value of these contracts, we believe that reporting entities should continue to follow the guidance in paragraph 62 of FAS 87. Paragraph 71 of FAS 106 also contains a similar practical expedient.
**Question 8-7:** What are the FAS 157 disclosure requirements for pension and OPEB plans?

**PwC Interpretive Response**

An employer is required to reflect in its balance sheet the funded status of its benefit plans (i.e., for pension plans, the difference between plan assets and the projected benefit obligation; for other postretirement benefit plans, the difference between plan assets and the accumulated postretirement benefit obligation). The funded status is not a fair value measurement. Paragraph A33 of FAS 157 provides guidance about its disclosure requirements. FAS 157, paragraph A33 states, in part:

> This Statement requires disclosures about the fair value of assets and liabilities recognized in the statement of financial position ... (emphasis added)

Since the pension plan assets are not separately recognized at fair value on the employers’ balance sheet, we believe that the FAS 157 disclosures do not apply to plan assets reflected in the funded status reported in the employers’ financial statements. The Board confirmed this at its November 14, 2007 meeting, but also expressed the view that certain FAS 157 disclosures would be useful for benefit plan assets (in particular, the level within which the plan assets fall in the fair value hierarchy). Therefore, the Board agreed to add a project to its agenda to address disclosures regarding the fair value of those plan assets through FASB Statement No. 132(R), *Employers’ Disclosures about Pensions and Other Postretirement Benefits – an amendment of FASB Statements No. 87, 88, and 106* (FAS 132(R)). Because the Board’s determination is specific to pensions and other postretirement benefits, and a project will be added to address fair value disclosures for these measurements, reporting entities should not analogize this guidance to other mixed attribute measurements. Rather, reporting entities should consider the relevant facts and circumstances pertaining to the asset or liability being measured when assessing the related disclosure requirements.

The view expressed above represents a change from our guidance as set forth in Question 22 in DataLine 2007-12. The change reflects additional interpretation and the FASB discussions outlined above.

**Plan Financial Statements**

As plan assets are reflected on the plan’s balance sheet at fair value (reduced by brokerage commissions and other costs normally incurred in a sale, if those costs are significant), we believe the FAS 157, paragraph 32 disclosures should be provided in the plan’s financial statements. Thus, plan assets will be segregated among Levels 1, 2, and 3 of the fair value hierarchy, and the rollforward information required under paragraphs 32(c) and 32(d) for any Level 3 inputs should be provided. See further discussion of disclosure requirements applicable to recurring measurements in Section 5.1, “Disclosures – Recurring Measurements.”
Chapter 9: Application – Nonrecurring Measurements
Chapter 9: Application – Nonrecurring Measurements

9.1 Business Combinations

FAS 141 generally requires assets acquired and liabilities assumed in a business combination to be initially measured at fair value. Paragraph 37 of FAS 141 provides guidance on measurement methods to be used for determining the value of certain assets and liabilities. In some cases, those measurement methods result in a value that is not intended to be a fair value measurement. In paragraph C21 of FAS 157, the FASB preserved those measurement methods, including them within the scope of “practicability exceptions” for the remaining period that FAS 141 is effective. In paragraph C22, the Board acknowledged the inconsistency of allowing practicability exceptions but decided to address the issue in other projects, such as the business combinations project completed with the issuance of FAS 141(R).

In December 2007, the FASB issued FAS 141(R). FAS 141(R) requires the measurement of assets acquired and liabilities assumed at their acquisition date fair values, with limited exceptions (e.g., employee benefit plans and deferred income taxes). FAS 141(R) incorporates the definition of fair value included within FAS 157, which is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Upon its effective date, FAS 141(R) will have a significant effect on the use of fair value measurements in business combinations as it eliminates most of the practicability exceptions provided under FAS 141.

The following section addresses the impact of FAS 157 on business combinations accounted for in accordance with FAS 141. Further PwC guidance will be issued in the future on the topic of business combinations accounted for in accordance with FAS 141(R).

9.1.1 Management’s Intended Use of An Asset

A common practice when determining the fair value of assets acquired in a business combination was to consider management’s intended use of the assets. Historically, if an acquirer did not intend to utilize an asset acquired in a business combination, a minimal amount of purchase price may have been allocated to the asset. Under FAS 157, entities may no longer consider management’s intended use for an asset acquired. FAS 141 and FAS 141(R) are within the scope of FAS 157 and, except in the case of a specific practicability exception, fair values should be determined based upon the exit price for an asset or the transfer price for a liability using the FAS 157 framework.

9.1.2 Business Combinations – Key Changes

FAS 157 impacts the way fair value will be measured for assets and liabilities acquired in a business combination. In addition, with the issuance of FAS 141(R), the impact will depend on the timing of the adoption of FAS 157 for nonrecurring, nonfinancial measurements and whether the combination occurs before or after the effective date of FAS 141(R) of January 1, 2009 (for calendar year-end companies).
Figure 9-1
Impact of FAS 157 on Business Combinations

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of account to be measured</strong></td>
<td>Cost is allocated to the assets acquired and liabilities assumed based on their estimated fair values.</td>
</tr>
<tr>
<td><strong>Definition of fair value</strong></td>
<td>• Cost is allocated to assets and liabilities based on fair value.</td>
</tr>
<tr>
<td></td>
<td>• FAS 141, paragraph 37 provides guidance on the methods for determining fair value for certain measurements (much of which represent practicability exceptions).</td>
</tr>
<tr>
<td></td>
<td>• Assets acquired and liabilities assumed that are measured at fair value are subject to the requirements of FAS 157.</td>
</tr>
<tr>
<td><strong>Measurement of fair value</strong></td>
<td>• Market prices should be used as basis, if available; indicates that quoted prices may not be representative of fair value (e.g., consideration of control premium could affect valuation).</td>
</tr>
<tr>
<td></td>
<td>• Management intent has been an important factor in the determination of the fair value of certain assets (e.g., intangible assets).</td>
</tr>
<tr>
<td></td>
<td>• Reporting entities must consider multiple valuation techniques when measuring the fair value of assets and liabilities.</td>
</tr>
</tbody>
</table>
Prior Practice | FAS 157
---|---
Disclosures | FAS 141 requires limited disclosure about fair value. | FAS 157 disclosures are not required upon initial recognition of fair value in a business combination. However, assets and liabilities measured at fair value after the initial valuation will be subject to the disclosure requirements of FAS 157.

**Question 9-1: How should a reporting entity identify market participants when measuring fair value in a business combination?**

**PwC Interpretive Response**

As described in FAS 157, paragraph 11, “the reporting entity need not identify specific market participants. Rather, the reporting entity should identify characteristics that distinguish market participants generally, considering factors specific to (a) the asset or liability, (b) the principal (or most advantageous) market for the asset or liability, and (c) market participants with whom the reporting entity would generally transact in that market.”

In identifying market participants for purposes of measuring the fair value of acquired assets and liabilities, market participants could be “strategic buyers,” “financial buyers,” or both:

- **Strategic buyers:** Strategic buyers could include the acquirer’s peers or competitors, or an entity seeking to diversify its operations. Typically, strategic buyers will have synergies specific to their existing operations, and may have the ability and willingness to transact for the same assets and liabilities that the acquirer just purchased.

- **Financial buyers:** Other buyers, including those that have no ownership interests in similar businesses or operations of the acquirer, may also be considered market participants in certain situations. These market participants, commonly referred to as financial buyers, may include individual investors, private equity and venture capital investors and financial institutional investors.

Given the recent increase in private equity investment, in some circumstances private equity buyers may be viewed as strategic buyers due to their deep industry expertise and relationships, and the potential synergies expected by combining portfolio companies.

In addition to considering strategic and financial buyers, a starting point for determining market participant assumptions in a business combination may be the actual acquirer. Since the acquirer successfully purchased the target company, it could look to itself to determine if it possesses unique characteristics, or whether such characteristics are similar to its competitors (strategic buyers) or financial buyers. Reporting entities can also look to the
other bidders in the bidding process in assessing whether the acquirer is representative of a market participant.

See further discussion of determination of market participants in Section 4.1.4, "Market Participants."

**Question 9-2: How will the change from an entity-specific to a market participant focus affect the measurement of the fair value of assets acquired in a business combination?**

**PwC Interpretive Response**

Prior to FAS 157, a reporting entity often considered its intended use of acquired assets when performing the purchase price allocation, attributing minimal or no value to certain assets in some situations, depending on management’s intent. As an example, a company may acquire a brand name in a business combination that it does not intend to use because its own brand name is more valuable. Prior to FAS 157, no value may have been attributed to the brand name in the purchase price allocation.

Upon adoption of FAS 157, a reporting entity will no longer be permitted to apply entity-specific assumptions when determining the fair value of the assets acquired in a business combination if those assumptions are not consistent with market participant assumptions. A reporting entity should apply FAS 157’s fair value measurement concepts when measuring the fair value of an asset for which management’s intended use is different from the highest and best use of the asset by market participants. For example, in developing a fair value measurement for an acquired brand, the reporting entity should perform an analysis of the facts and circumstances specific to the acquired asset, including considering market participant assumptions regarding the highest and best use of the asset, potential market participant synergies expected from the brand, and defensive attributes of the brand.

**Question 9-3: Should a reporting entity attribute fair value to assets acquired in a business combination that the acquirer intends to hold for defensive purposes?**

**PwC Interpretive Response**

A reporting entity enters into a business combination transaction which will allow it to acquire and hold an asset that directly competes with its own products or services. In evaluating fair value in a business combination, the highest and best use of the asset would need to be assessed. If the highest and best use from the perspective of market participants includes an assumption that the asset would be actively utilized on its own or with other assets, the asset should be valued using an in-use valuation premise regardless of the fact that it is being held for defensive purposes by the acquirer and will not be utilized. Conversely, if market participants also held complementary assets that would similarly benefit from locking up the acquired asset, using the acquirer’s intent and assumptions may be appropriate when valuing that asset based on a “defensive value” concept. Finally, if the asset is of a nature such that market participants would not value it in an exit market, the acquirer may conclude that minimal or no value is attributable to the asset.
Question 9-4: Under FAS 157’s highest and best use concept, should a customer relationship intangible asset be recognized upon the acquisition of a vendor or supplier?

**PwC Interpretive Response**

We believe that FAS 157 does not change the conclusions reached in EITF Issue No. 04-1, *Accounting for Preexisting Relationships between the Parties to a Business Combination* (EITF 04-1). EITF 04-1 addresses the accounting and disclosure requirements for pre-existing relationships between parties in a business combination. Pursuant to EITF 04-1, all pre-existing relationships between two parties that have consummated a business combination should be evaluated to determine whether settlement of a pre-existing contract has occurred requiring accounting separate from the business combination.

We continue to believe that when the acquirer is a customer of the acquiree, the acquirer should not recognize a customer relationship intangible asset with itself since a “customer relationship” no longer exists after the acquisition. A customer relationship with oneself does not meet either the contractual-legal or the separable criterion of FAS 141, either of which is required for recognition as an intangible asset separate from goodwill.

**Question 9-5: How should the fair value of debt assumed in a business combination be measured?**

**PwC Interpretive Response**

EITF Issue No. 98-1, *Valuation of Debt Assumed in a Purchase Business Combination* (EITF 98-1), clarified that debt assumed in a purchase business combination should be recorded at its fair value. EITF 98-1 was not amended or nullified by FAS 157. EITF 98-1 specifies that the credit standing of the combined entity in a purchase business combination should be used as the basis for the interest rate to be used when determining the fair value of the acquired debt. However, if the credit characteristics of the debt acquired remain unchanged after the acquisition because the debt remains the obligation of the acquired entity, or other credit features are identifiable and remain in place, it may not take on new characteristics as a result of the acquisition and the prior credit characteristics of the obligation would survive the transaction as the basis for valuation of the liability.

The methodology described in EITF 98-1 is consistent with the market participant approach required under FAS 157. For example, if on a post-acquisition basis, acquired debt is credit-enhanced because the debt holders become general creditors of the new (combined) entity, the acquired debt would follow the characteristics of the acquirer’s credit (or something in-between the credit standing of the two entities, depending on the facts and circumstances).
The following interpretive example illustrates the application of these concepts:

Example 9-1
Long-term Debt – Credit Rating after a Business Combination

Assume an AA-rated entity acquires a BB-rated entity. The BB-rated entity had outstanding debt, which the AA-rated entity will assume. Should the acquirer's credit rating change the fair value of the acquired debt?

In this simple fact pattern, the fair value of the acquired debt may incorporate a post-acquisition rating of the combined entity. However, if the acquired debt had included specific security, guarantees, and/or collateral characteristics that remain intact after the business combination (i.e., with no change or enhancement by the acquirer), there would be no change in its credit characteristics post-acquisition for purposes of determining its fair value. Therefore, the interest rate input should be based on a rating of BB.

Question 9-6: Will FAS 157 result in the recognition of Day One gains or losses in a business combination?

PwC Interpretive Response
For some acquisitions accounted for as business combinations, the sum of the amounts assigned to assets acquired and liabilities assumed (based on fair value) will exceed the cost of the acquired entity (sometimes called a bargain purchase). Paragraph 44 of FAS 141 states, in part:

That excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefit plans, and (e) any other current assets. (footnotes omitted)

Therefore, a bargain purchase may not result in a Day One gain recorded in earnings.

For other acquisitions, however, the cost to the acquiring entity may exceed the sum of the fair values of the assets acquired and the liabilities assumed. Amounts paid in excess of fair value are recognized as a component of goodwill in accordance with FAS 141 and should not be recognized as a Day One loss. In those cases, some reporting entities may believe that they overpaid for the acquired business. This raises a question as to whether goodwill is impaired. A reporting entity may consider this situation as one data point when performing the first post-acquisition goodwill impairment test as described in Question 9-11 below.
Question 9-7: Is FAS 157 applicable to business combinations completed prior to adoption of the Standard?

PwC Interpretive Response

If a reporting entity closes a business combination prior to its adoption of FAS 157, we believe FAS 157 would not be applied when determining the fair value of the assets acquired and liabilities assumed, because FAS 141 allows the accounting for business combinations to be finalized subsequent to the closing date. However, reporting entities should be aware that subsequent evaluations of goodwill, acquired indefinite-lived intangible assets and acquired long-lived assets may be impacted by adoption of FAS 157. For example, potential impairment charges could be magnified if entity-specific assumptions utilized in the purchase price allocation are significantly different from the assumptions of market participants that would be applied when using FAS 157.

9.2 Goodwill and Indefinite-Lived Intangible Assets

FAS 141 provides specific guidance for the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. The cost of an acquired entity is allocated to the assets acquired (including other intangible assets) and liabilities assumed, based on their estimated fair values, subject to practicability exceptions, as of the date of acquisition; the residual is allocated to goodwill. See specific consideration of issues associated with fair value measurements in a business combination in Section 9.1, “Business Combinations.”

FAS 157 does not change the framework for application of FAS 142; however, it impacts the way fair value will be measured in performing impairment tests and in determining the amount of the impairment, if any. For example, if a reporting entity is performing its annual impairment test and traditionally has used a discounted cash flow analysis, on adoption of FAS 157 it will need to consider whether its inputs are consistent with market participant inputs as defined in the Standard and whether a market or cost approach is appropriate in the circumstances. Key considerations and changes from previous practice as a result of adopting FAS 157 include the following:

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**Figure 9-2**

**Impact of FAS 157 on Goodwill and Indefinite-Lived Intangible Assets**

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of account to be measured</strong></td>
<td>Goodwill – measured at level of reporting unit; Indefinite-lived intangible assets – Individual or groups of indefinite-lived intangible assets.</td>
</tr>
</tbody>
</table>

**continued**
<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition of fair value</strong></td>
<td>FAS 142, paragraph 23, “…the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.”</td>
</tr>
<tr>
<td><strong>Test for recoverability</strong></td>
<td>Carrying value is not recoverable if:&lt;br&gt;- Goodwill – reporting unit’s carrying value exceeds its fair value;&lt;br&gt;- Indefinite-lived intangible assets – carrying value exceeds its fair value.</td>
</tr>
<tr>
<td><strong>Measurement of fair value for both step 1 and step 2</strong></td>
<td>• Market prices should be used as basis, if available; indicates that quoted prices may not be representative of fair value. Recognition of control premium is allowed when appropriate.&lt;br&gt;- “Present value technique is often the best available technique.” Reference to CON 7 probability weighted approach; encouraged use of market participant assumptions.</td>
</tr>
<tr>
<td><strong>Disclosures</strong></td>
<td>Required to disclose method used to determine fair value, if impairment is recognized.</td>
</tr>
</tbody>
</table>

FAS 142 provides guidance related to the initial accounting for intangible assets acquired outside a business combination and addresses the accounting for and financial reporting of goodwill and intangible assets subsequent to their initial recognition (i.e., post acquisition accounting). Key fair value measurements required by FAS 142 include the following:

- Goodwill will be tested for impairment at the reporting unit level on a fair value basis at least annually;
- Intangible assets deemed to have an indefinite life will be tested for impairment using a fair value method at least annually; and
• An intangible asset that is acquired outside of a business combination will be initially recognized and measured based on its fair value.

Intangible assets that are subject to amortization are tested for impairment in accordance with the requirements of FAS 144. The impact of FAS 157 on impairment tests under FAS 144 is further discussed in the Section 9.3, “Long-Lived Assets” below.

In accordance with FAS 142, a reporting entity is required to test goodwill and indefinite-lived intangible assets as follows:

• **Goodwill** – FAS 142 outlines a two-step impairment test that should be used to identify potential goodwill impairment and to measure the amount of impairment loss to be recognized (if any). Step 1 of the goodwill impairment test compares the fair value of the reporting unit to its carrying value. If the reporting unit carrying value is greater than its fair value, any impairment loss is determined in step 2 of the goodwill impairment test.

• **Indefinite-lived intangible assets** – An impairment loss is recognized if the carrying value of the indefinite-lived intangible asset exceeds its fair value.

Fair value is the measurement basis for these impairment tests. FAS 157 does not change the overall framework for determining whether goodwill or other indefinite-lived intangible assets are impaired; however, it may change the way fair value is measured for purposes of performing the impairment tests and measuring impairment losses. Prior to the issuance of FAS 157, FAS 142 stated that “quoted market prices in active markets are the best evidence of fair value” and should be used if available. FAS 142 also allowed the use of a revenue multiple or similar performance measurement to determine fair value. However, to the extent this information was not available or applicable, FAS 142 referred to the use of a present value technique in accordance with the guidance of CON 7.

FAS 157 deleted references in FAS 142 discussing the use of present value techniques in the calculation of fair value. The use of a present value technique may still be appropriate; however, the reporting entity must also consider whether other techniques are appropriate in the circumstances. Key considerations in the calculation of fair value for the purposes of determining the amount of impairment of goodwill or indefinite-lived intangible assets include the following:

• **Principal or most advantageous market**: In determining fair value, a reporting entity must determine the principal or most advantageous market. In general, there may not be a principal market for the sale of the reporting unit or indefinite-lived intangible asset being considered in the impairment analysis. To the extent the reporting entity determines that there is no principal or most advantageous market, it should assess potential market participants and it should develop a hypothetical market based on its assessment of market participant assumptions.

• **Highest and best use**: The reporting entity should assess potential markets, considering the highest and best use of the asset, whether in-use or in-exchange. In making this assessment, the reporting entity must consider the reporting unit as a unit of account; however, it may also consider whether a
reporting unit should be aggregated with other assets in performing the valuation (see further discussion under Question 9-8 below).

Note that the highest and best use of the reporting unit from the perspective of market participants may differ from that of the reporting entity. The reporting entity must use market participant assumptions in this analysis.

- Determine the valuation technique: The reporting entity should consider the income, market, or cost approaches in determining the appropriate method(s) to calculate fair value. In some cases multiple valuation techniques will be appropriate and should be used. The final determination of fair value will depend on the results of valuation methods used and management's judgment.

- Incorporate market participant assumptions: The calculation of fair value must be based on market participant assumptions.

The following example further illustrates the application of FAS 157 in performing Step 1 of a goodwill impairment analysis:

**Example 9-2**  
**Fair Value Measurement – Goodwill Impairment**

In 2000, Company C acquired a publicly-traded company, Subsidiary A, for $900. At the time of the acquisition, Company C determined that $100 of the purchase price related to goodwill. Subsidiary A's operations are unrelated to Company C and Company C decided to continue to operate Subsidiary A as a separate company. None of the goodwill was allocated to Company C’s other reporting units. Company C determines that Subsidiary A is a reporting unit. Subsidiary A is still a public registrant due to publicly traded debt.

Demand for Subsidiary A’s services has declined over the period since acquisition and its debt, which is not guaranteed or enhanced by Company C, is trading at a substantial discount. The carrying value of the reporting unit at the time of the impairment test is $700. In performing its annual goodwill impairment test, Company C calculates the fair value of Subsidiary A as follows:

<table>
<thead>
<tr>
<th>Determine unit of account</th>
<th>In accordance with FAS 157, the unit of account is established by the guidance in FAS 142. In this case, Subsidiary A is a separate reporting unit which is the unit of account used for measurement under FAS 142.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluate valuation premise</td>
<td>Company C considers whether the highest and best use of the reporting unit (Subsidiary A) will be in-use or in-exchange. In this case, Company C has no complementary assets that would provide additional value to a market participant. As such, Company C concludes that the valuation premise for the reporting unit is in-exchange (as the reporting unit is being used as a single group).</td>
</tr>
</tbody>
</table>

continued
<table>
<thead>
<tr>
<th>Assess principal market</th>
<th>Company C determines that there is no principal market for the sale of Subsidiary A as a unit.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determine the most advantageous market</td>
<td>Company C determines that there is no known or liquid market for Subsidiary A. As such, Company C determines that it would most likely sell Subsidiary A to one of its competitors (market participants with interests similar to its own) or spin off Subsidiary A as a separate entity for sale to a financial buyer or through public markets. Company C will hypothecate market participant assumptions based on its expectations of the assumptions of these competitors and/or potential financial investors.</td>
</tr>
</tbody>
</table>
| Determine valuation technique | Company C considers the use of each of the valuation techniques as follows:  
  - Market approach – Company C has market information available based on the significant discount on Subsidiary A’s outstanding debt. This information, combined with publicly available information about the recent sale of a similar company, allows Company C to develop an estimate of the market value of Subsidiary A. The analysis concludes that Subsidiary A has a fair value of $500.  
  - Income approach – Company C performs a discounted cash flow analysis based on its expectations of potential net income from the subsidiary. Company C concludes that market participants would shut down certain locations and would scale back other operations. These assumptions are incorporated in the cash flow analysis along with other market participant assumptions. The analysis concludes that the fair value is $550.  
  - Cost approach – As the analysis relates to an operating business, Company A concludes that the cost approach is not applicable. |
| Determine indicative value | Company C determines that the income approach provides the best estimate of fair value. As the fair value of the reporting unit is less than its carrying value, Company C will complete step 2 of the goodwill impairment analysis to determine the amount of the goodwill impairment loss. |

As noted in this example, the determination of the fair value of a reporting unit in a goodwill impairment analysis may be complex and requires consideration of numerous factors. The following questions and interpretive responses address specific application issues:
Question 9-8: Can a reporting entity combine reporting units in performing its goodwill impairment test?

PwC Interpretive Response

While FAS 157 provides the relevant guidance on how to determine the fair value of a reporting unit, it does not prescribe the unit of account to be used for assets or liabilities, but rather refers to other applicable GAAP. FAS 142, paragraphs 18 and 19, require that goodwill be tested for impairment at the reporting unit level.

Paragraph E22(d) of FAS 157 amends FAS 142 to state, “the fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date.” Based on this guidance, we believe that FAS 142, as amended, defines the unit of account as the reporting unit on a standalone basis.

However, as discussed above, the valuation premise used to measure the fair value of an asset may be in-use or combined with other assets as a group. FAS 157, footnote 8 states:

> The fair value of an asset in-use is determined based on the use of the asset together with other assets as a group (consistent with its highest and best use from the perspective of market participants), even if the asset that is the subject of the measurement is aggregated (or disaggregated) at a different level for purposes of applying other accounting pronouncements.

In some cases, the highest and best use for a reporting unit may be enhanced if the reporting unit is combined with other assets of the reporting entity. For example, a reporting entity comprised of two reporting units may benefit from the synergies derived from the interrelationship between the two reporting units when measuring the fair value of those reporting units. If market participants would recognize the synergies resulting from combining the two reporting units, it may be appropriate to allocate the enhanced value resulting from those synergies in determining the fair value of the individual reporting units.

Example 9-3

Highest and Best Use – Combining Reporting Units

Individual or small groups of production plants may represent individual reporting units but may achieve significant production synergies if operated and managed as a combined group. In this example, when contemplating the exit value of production plants, assume that market participants often consider the value in grouping plants together and that management observes that similar plants are frequently sold as bundled groups.

continued
In this fact pattern, the company may conclude that the highest and best use for the production facilities is within strategic groupings that follow its view of how market participants would purchase the assets at their highest exit value. However, when applying this interpretation, companies should not arbitrarily group reporting units to mitigate potential impairment charges and should have a consistent and reasonable basis for doing so, based on management’s view of what market participants would do or expect.

An alternative view would limit asset groupings at the level of the reporting unit. Assets within the reporting unit would be grouped to their highest and best use but the reporting unit itself would be valued as a standalone entity. Reporting entities may support a policy of valuing reporting units on a standalone basis by reference to paragraph E22(d) of FAS 157, which refers to valuation of the reporting unit as a whole.

We expect that as practice develops, further guidance may be issued on this topic.

**Question 9-9: Does FAS 157 provide any transition relief for valuations previously prepared using entity-specific assumptions?**

**PwC Interpretive Response**

FAS 157 provides that fair value measurements within its scope should be determined from the perspective of market participants. FAS 157 does not provide an accommodation to grandfather previous accounting practices.

A reporting entity may have intangible assets acquired prior to adoption of FAS 157 that were valued based on entity-specific assumptions. In some cases, little or no value may have been assigned to certain assets acquired as the reporting entity did not intend to use those assets post-acquisition. The valuation of these assets would have impacted the initial allocation of purchase price to goodwill at the time of the business combination. Subsequent to the adoption of FAS 157, the incorporation of market participant assumptions in the determination of fair value may result in an increase in value assigned to these intangible assets when performing step 2 of the goodwill impairment test.

If a reporting entity is required to complete step 2 of a goodwill impairment test, it compares the implied fair value of the reporting unit’s goodwill to its carrying value. This step requires the reporting entity to determine the fair value of all separately identifiable assets and liabilities in that reporting unit using market participant assumptions, with the excess value, if any, assigned to goodwill. The incorporation of market participant assumptions in the determination of fair value may result in value being attributed to an intangible asset for purposes of step 2 of the goodwill impairment test that had little or no value ascribed to it during the original allocation of purchase price. The increase in value assigned to these assets may reduce the implied fair value of goodwill in the reporting unit, potentially resulting in the recording of a goodwill impairment in situations where an impairment would otherwise not have been recorded absent a change in methodology.
As described in this scenario, applying market participant assumptions in the measurement of fair value in step 2 of a goodwill impairment test may result in the recognition of impairment losses that are significantly different than those arising from previous practices.

**Question 9-10: How should a reporting entity incorporate available quoted market prices in its goodwill impairment analysis?**

**PwC Interpretive Response**

Assume a public company with a single reporting unit is in the process of performing its annual goodwill impairment test. Under step 1 of the FAS 142 model, the company has noted that the book value of its net assets is higher than its current market capitalization. FAS 142, paragraph 23, as amended by FAS 157, states, in part:

> Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole. Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual security, therefore, need not be the sole measurement basis of the fair value of a reporting unit. (emphasis added)

FAS 157 brings forward the guidance regarding control premiums in FAS 142. Accordingly, a reporting entity may conclude that its unadjusted market capitalization is not representative of fair value and it would not automatically fail step 1 of the goodwill impairment test. However, the reporting entity’s market capitalization is one data point that should be considered when determining the fair value of the reporting unit. Any adjustment to the available market data should be supportable in the circumstances. Furthermore, adjustments to market data may result in a classification of the fair value measurement within Level 3 of the fair value hierarchy. It may also be appropriate to calculate fair value using an income approach.

**Question 9-11: Can the original transaction price be used as an indicator of fair value in the first post-acquisition goodwill impairment test? What if the next highest bid was substantially lower?**

**PwC Interpretive Response**

When assessing fair value in the first post-acquisition goodwill impairment test, an acquirer may consider the purchase price as a data point in determining fair value unless there is contradictory evidence. Paragraph 17 of FAS 157 requires that a reporting entity consider factors specific to the transaction in determining whether the transaction price represents fair value. The fact that
the next highest bid was substantially lower than an acquirer’s bid does not
necessarily mean that the transaction price is not representative of fair value.
However, in performing the evaluation, the acquirer should also consider
developments that may have occurred since the purchase transaction in
assessing whether the transaction price should be adjusted to reflect changes
in fair value. Generally, a reporting entity should make a new detailed
determination of fair value when performing its first post-acquisition annual
impairment test.

**Question 9-12:** Which FAS 157 disclosures are required for tests of
impairment of goodwill and indefinite-lived assets? What disclosures are
required if an impairment is recognized?

**PwC Interpretive Response**

The impairment models for goodwill and indefinite-lived intangible assets are
fair value-based assessment models. However, goodwill and indefinite-lived
intangible assets are not periodically remeasured at fair value. Rather, the
amounts are initially recognized at fair value and become a nonrecurring fair
value measurement only when an impairment loss is recorded. Therefore,
consistent with the guidance included in FAS 142, there is no requirement to
disclose information about the fair value used in the impairment test, unless an
impairment loss is recognized.

In the period in which an impairment of goodwill or indefinite-lived intangible
assets is recognized in the financial statements, the nonrecurring disclosure
requirements in paragraph 33 of FAS 157 should be followed (in addition to
those disclosures required by FAS 142).

This information will supplement FAS 142’s required disclosures about the
basis for determination of fair value in the event an impairment loss is
recognized.

**9.3 Long-Lived Assets**

Long-lived assets (outside of a business combination) are recorded at cost and
depreciated or amortized. However, there are certain fair value measurements
associated with impairments of long-lived assets. Fair value considerations
and application issues specific to long-lived assets are discussed below.

**9.3.1 Impairment or Disposal of Long-Lived Assets to be Held and Used**

In accordance with FAS 144, in the first step of an impairment evaluation of
long-lived assets to be held and used, a reporting entity is required to assess
the recoverability of an asset (or asset group) in response to a “triggering
event.” The carrying amount of an asset or asset group is not recoverable if it
exceeds the sum of the undiscounted cash flows expected to result from the
entity’s use and eventual disposition of the asset. If the carrying amount is not
recoverable, step 2 of the evaluation is triggered and the reporting entity is
required to record an impairment loss equal to the difference between the
carrying amount and fair value of the asset (or asset group) derived in step 2
of the FAS 144 impairment test.
In step 1, a reporting entity will determine if an asset or asset group is not recoverable based on an entity-specific undiscounted cash flow analysis. FAS 157 does not impact the initial test for recoverability as this test is not based on the fair value of the asset (or asset group). However, FAS 157 changes the definition and determination of fair value for step 2 of the impairment analysis. Prior to the issuance of FAS 157, FAS 144 stated that “quoted market prices in active markets are the best evidence of fair value” and should be used if available. However, to the extent market prices were not available, FAS 144 referred to use of a present value technique in accordance with the guidance of CON 7.

As a result of the adoption of FAS 157, the calculation of fair value will no longer default to a CON 7 present value technique. The use of a present value technique may be appropriate; however, the reporting entity must also consider all valuation techniques appropriate in the circumstances and for which market participant inputs can be obtained without undue cost and effort. This may include a CON 7 expected value approach.

Key considerations and changes from previous practice as a result of application of FAS 157 include the following:

**Figure 9-3**

**Impact of FAS 157 on Long-Lived Assets to be Held and Used**

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of account to be measured</strong></td>
<td><strong>No change – Unit of account as determined by FAS 144.</strong></td>
</tr>
<tr>
<td>Held and used: lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.</td>
<td></td>
</tr>
<tr>
<td><strong>Test for recoverability</strong></td>
<td><strong>No change to previous practice.</strong></td>
</tr>
<tr>
<td>The carrying amount is not recoverable if it exceeds the sum of the undiscounted cash flows based on entity’s planned use.</td>
<td></td>
</tr>
</tbody>
</table>

*continued*
Prior Practice | FAS 157
--- | ---
Measurement of fair value | • Market prices should be used, if available.
• “Present value technique is often the best available valuation technique.”
• Reference to CON 7 probability weighted approach; encouraged use of market participant assumptions.
• Income, cost, or market valuation technique(s) should be used as appropriate.
• Amends FAS 144 by deleting reference to CON 7. Expected present value technique may be an appropriate valuation approach.
• Generally, there is no principal market; determination of market participants may impact conclusions.
• Requires use of market participant assumptions and a determination of highest and best use.

Disclosures | Required disclosures included method used to determine fair value.
FAS 157 nonrecurring disclosures required if an impairment loss is recognized.

Key considerations in the calculation of fair value for the purposes of determining the amount of impairment of a long-lived asset to be held and used include the following:

- Principal or most advantageous market: In determining fair value, a reporting entity must determine the principal or most advantageous market. In many cases, there may not be a principal market for the sale of the long-lived asset (or asset group) being considered in the impairment analysis. To the extent the reporting entity determines that there is no principal or most advantageous market, it should assess potential market participants and it should hypothecate market participant assumptions.

- Highest and best use: The reporting entity should assess potential markets, considering whether the highest and best use of the asset (or asset group) is in-use or in-exchange. Note that the highest and best use of the asset from the perspective of market participants may differ from that of the reporting entity; the entity must use market participant assumptions in this analysis.

- Determine the valuation technique: The reporting entity should consider whether the income, market, or cost approach is the appropriate methodology to calculate fair value. FAS 157 amends FAS 144 to state that “an expected present value technique will often be the appropriate technique with which to measure fair value” for long-lived assets that have uncertainties both in timing and amount. However, in some cases the
market or cost approach may be appropriate; the reporting entity should determine the appropriate technique(s) based on the specific facts and circumstances.

- Incorporate market participant assumptions: The calculation of fair value must be based on market participant assumptions.

FAS 157, example 4 (paragraph A14), provides an example of the application of the FAS 157 framework in an impairment analysis. This guide includes the following simple example for illustrative purposes. In many circumstances, long-lived assets being assessed for impairment would be part of a group of assets and in those instances, reporting entities would need to consider that the application of the FAS 157 framework may render a different outcome. Issues related to FAS 144 such as asset groupings and allocation of losses are beyond the scope of this guide.

Example 9-4
Fair Value Measurement – Long-Lived Asset Impairment

In 2002, Company A purchased equipment for use in its production process. The equipment was originally recorded as a fixed asset at the purchase price (entry price), which established the initial carrying value. The current carrying value of the equipment is $150. Recently, more efficient machines have been introduced to the marketplace and the price per unit of the products produced by the new machines declines significantly. Accordingly, Company A performs step 1 of the impairment analysis and determines that the carrying value of its equipment is not recoverable. In response, Company A performs a fair value assessment in accordance with FAS 157 as follows:

<table>
<thead>
<tr>
<th>Determine unit of account</th>
<th>The individual equipment has separate identifiable cash flows. As such, the separate piece of equipment is the unit of account under the guidance of FAS 144.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluate valuation premise</td>
<td>Company A considers whether the highest and best use of the asset will be in-use or in-exchange. In this case, Company A has no complementary assets that would provide additional value to a market participant. As such, Company A concludes that the valuation premise is in-exchange.</td>
</tr>
<tr>
<td>Assess principal market</td>
<td>Company A determines that it does not have a principal market for the sale of this equipment as it has not previously transacted in similar sales and does not expect to do so in the future.</td>
</tr>
<tr>
<td>Determine the most advantageous market</td>
<td>Company A determines that there are various potential wholesale markets for the sale of similar equipment; however, there are no markets for the sale of identical assets. As such, the Company determines that it would most likely sell the equipment to one of its competitors (market participants with interests similar to its own). Company A will hypothecate a market based on its expectations of the assumptions of these competitors.</td>
</tr>
</tbody>
</table>
Determine valuation technique

Company A considers the use of each of the valuation techniques as follows:

- Market approach – the equipment is old and has been superseded by more modern equipment. As a result, after reasonable efforts, the Company was not able to develop pricing inputs for a market approach.

- Income approach – Company A performs a discounted cash flow analysis based on its expectations of potential product sales over the next seven years. It assumes the equipment will be scrapped in 2015. Management concludes that a competitor would transfer the equipment to another location with a cheaper workforce. This assumption is incorporated in the cash flow analysis along with other market participant assumptions. The analysis concludes that the fair value is $80.

- Cost approach – Company A assesses the replacement cost of the equipment and determines that it will cost $120 to purchase a new machine. However, the newer equipment has additional capabilities not incorporated in the current equipment.

Determine fair value

Because the replacement equipment incorporates certain upgrades and as there is no clear resale market, Company A determines that the income approach provides the best estimate of fair value. As a result, the equipment will be written down to a carrying value of $80.

As noted in this example, the determination of fair value in an impairment analysis may be complex and requires consideration of numerous factors. The following questions and interpretive responses address certain issues in application:

**Question 9-13: After adoption of FAS 157, what is the appropriate valuation methodology when assessing long-lived assets to be held and used?**

**PwC Interpretive Response**

FAS 144 states that an asset (or asset group) is not recoverable if the undiscounted cash flows expected from the use and disposition of the asset (or asset group) is less than its carrying amount. FAS 144 also states that the undiscounted cash flow analysis should incorporate an entity’s own assumptions about its use of the asset group.

FAS 157 did not amend the recoverability model prescribed in step 1 of the impairment test under FAS 144, only the guidance it provided in determining fair value in step 2. Thus, an entity’s own assumptions should continue to be utilized in performing step 1 of the held and used impairment model of FAS 144 as this step is not a fair value based assessment model. However, if a reporting entity fails step 1 of the test, the reporting entity must then follow the guidance in FAS 157 to determine the fair value of the asset (or asset group) for purposes of determining the impairment loss. Reporting entities commonly
utilize a present value technique to determine fair value and historically may have based the fair value amount on the same cash flows that it developed in performing the first step of the test, to the extent that it was the only information available without undue cost and effort.

After adoption of FAS 157, a reporting entity will first need to consider the valuation premise associated with the unit of account being measured. Valuation technique(s) appropriate in the circumstances should be evaluated with consideration of the market, cost, and income approaches when determining fair value under Step 2 of the FAS 144 impairment test. Finally, valuation inputs must be determined for each appropriate valuation technique. For example, a market approach may be appropriate if the reporting entity has recently bought or sold similar assets or if there have been other recent sales of similar assets, with public disclosure of sale terms. If a reporting entity determines that the income approach is appropriate, it will need to ensure that if it uses entity-specific assumptions in the second step of the test, that they are adjusted to reflect market participant assumptions. It should make any necessary modifications to the cash flows, prior to applying a discount rate to calculate the fair value of the asset (or asset group) in step 2.

**Question 9-14: What is the appropriate unit of account in an impairment measurement of a long-lived asset to be held and used?**

**PwC Interpretive Response**

The determination of the asset or asset group being evaluated in a long-lived asset impairment analysis may have a significant impact on whether an impairment is recognized and, if so, on the amount of the impairment. As described in paragraph 6 of FAS 157, the unit of account determines what is being measured, based on guidance provided by other applicable accounting standards. This guidance results in no change from previous practice in determining the unit of account when measuring impairment of a long-lived asset. FAS 144, paragraph 4, states, in part:

If a long-lived asset (or assets) is part of a group that includes other assets and liabilities not covered by this Statement, this Statement applies to the group. In those situations, the unit of accounting for the long-lived asset is its group. For a long-lived asset or assets to be held and used, that group (hereinafter referred to as an *asset group*) represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

The following example demonstrates the determination of the appropriate unit of account in a long-lived asset impairment analysis:
Example 9-5
Unit of Account – Long-Lived Asset Impairment

For example, assume a company is evaluating the impairment of a long-lived asset. The asset is subject to an operating lease with a third party. In evaluating the fair value of the asset, the company considers whether the contractual cash flows from the lease can be included when using the income approach.

In this example, to determine if a lease contract is part of an asset grouping, the reporting entity must determine if the lease is the source of cash flow for the asset at the lowest level as required by FAS 144. This may involve examining historical uses of the asset and associated cash flows or the contractual terms of the lease itself (e.g., is it asset specific?) to make the determination. Assuming the lease contract is associated with the asset as a source of cash flow at the lowest level, as required by FAS 144, it will be considered part of the asset grouping and included in the determination of the total amount of the impairment.

In addition, while including the lease cash flows may result in a lower overall impairment, note that the impairment must be allocated only to the long-lived asset itself and not to the lease contract.

Consistent with this guidance, in measuring fair value for an impairment analysis, the reporting entity should determine the asset (or asset group) based on the lowest level of separable cash flows. Judgment is required when determining asset groupings under FAS 144. Once those groupings are determined, they would establish the unit of account for valuation purposes under FAS 157. However, in accordance with paragraph 14 of FAS 144, although asset groupings establish the unit of account, an individual asset in the group would not be recorded at an amount below its fair value. As such, a long-lived asset subject to an operating lease that is below market value that causes the asset group to also be below market value would not give rise to an impairment of the associated long-lived asset.

Question 9-15: What are the FAS 157 disclosure requirements for an impairment of a long-lived asset to be held and used?

PwC Interpretive Response

In the period in which an impairment loss on a long-lived asset to be held and used is reported in the financial statements, the nonrecurring disclosure requirements in paragraph 33 of FAS 157 should be followed in addition to those disclosures required by FAS 144.

FAS 144 already requires that entities disclose the basis for determining fair value; however, the additional disclosures required by FAS 157 will increase the transparency of measurements of impairment.
9.3.2 Impairment or Disposal of Long-Lived Assets to be Disposed of by Sale

In accordance with FAS 144, paragraph 30, a long-lived asset (disposal group) should be classified as held for sale in the period in which certain criteria are met. FAS 144, paragraph 34 states, in part:

A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell.

A reporting entity should evaluate its estimates of fair value less cost to sell each period to determine whether a change in estimate is warranted. Subsequent upward and downward revisions in the estimate should be recorded as adjustments to the carrying amount of the asset; however, any upward revisions may not result in a new basis that exceeds the carrying value as of the date the decision to sell was made.

Note that cost to sell represents a transaction cost that is including in the carrying amount of the long-lived asset held for sale under FAS 144, but is not a component of the asset’s fair value.

Fair value should be measured in accordance with the requirements of FAS 157. The approach to the calculation of fair value for long-lived assets to be disposed of by sale is similar to the approach outlined for long-lived assets to be held and used as discussed in Section 9.3.1, “Impairment or Disposal of Long-Lived Assets to be Held and Used,” above. Reporting entities evaluating fair value for long-lived assets to be disposed of by sale may refer to that guidance in considering valuation premise, potential markets, market participants, and application of valuation technique(s). Specific considerations for long-lived assets to be disposed of by sale are further discussed below.

9.3.2.1 Long-Lived Assets Held for Sale - FAS 157 Disclosure Requirements

Because an asset held for sale must be assessed at each reporting period and adjusted for changes as described above, a question arises as to whether that subsequent evaluation each period is considered to be a recurring fair value measurement subject to the recurring disclosure requirements in paragraph 32 of FAS 157.

Similar to step 1 of the goodwill impairment test, the subsequent evaluation for changes in fair value less cost to sell for the disposal group is a recurring assessment, but any adjustments are recognized on a non-recurring basis. An adjustment to assets held for sale to reflect fair value less cost to sell is recognized only in periods in which that fair value does not exceed the carrying value at the date the decision to sell was made. Therefore, as this is not a recurring measurement, we believe that the recurring measurement disclosures are not applicable. However, the nonrecurring disclosure requirements of paragraph 33 of FAS 157 will apply each time that the recorded amount of the long-lived assets held for sale is adjusted.
9.4 Asset Retirement Obligations

FAS 143, paragraph 3, requires that a reporting entity "recognize the fair value of a liability for an asset retirement obligation (ARO) in the period in which it is incurred if a reasonable estimate of fair value can be made." The fair value was based on "the amount at which that liability could be settled in a current transaction between willing parties, that is, other than in a forced or liquidation transaction." The obligation is initially measured at fair value with subsequent changes limited to amounts related to the passage of time and changes in the timing or amount of future cash flows. FAS 157 may not have a significant impact on the measurement of asset retirement obligations. Key considerations and a summary of changes from previous practice are as follows:

Figure 9-4
Impact of FAS 157 on Asset Retirement Obligations

<table>
<thead>
<tr>
<th>Prior Practice</th>
<th>FAS 157</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of account to be measured</strong></td>
<td>Legal obligations associated with the retirement of tangible long-lived assets; measured separately for individual assets.</td>
</tr>
<tr>
<td><strong>Definition of fair value</strong></td>
<td>FAS 143, paragraph 7, “…the amount at which that liability could be settled in a current transaction between willing parties, that is, other than in a forced or liquidation transaction.”</td>
</tr>
</tbody>
</table>
| **Initial measurement of fair value** | • Market prices should be used, if available.  
   • Estimate based on best available information, including results of present value or other valuation techniques.  
   • “Expected cash flow approach will usually be the only appropriate technique.”  
   • Encouraged use of market participant assumptions; use of credit-adjusted risk free rate. | No significant change:  
   • “An expected present value technique will usually be the only appropriate technique with which to estimate the fair value.”  
   • Based on assumptions of market participants; incorporates credit-adjusted risk-free rate. |

continued
In determining the fair value of AROs, FAS 143 stated that quoted prices in active markets should be used if available; however, the measurement typically defaulted to a present value technique prepared in accordance with the guidance of CON 7. FAS 143 encouraged the use of market participant assumptions in preparing the present value analysis.

FAS 157 does not significantly change the methodology used to estimate the initial fair value of an asset retirement obligation. Paragraph E23(b) of FAS 157 states, in part:

An expected present value technique will usually be the only appropriate technique with which to estimate the fair value of a liability for an asset retirement obligation.

This guidance is consistent with the previous guidance in FAS 143. FAS 143 provides a practicability exception, which requires disclosure if a reasonable estimate of fair value cannot be made. This exception is retained by FAS 157.

### 9.4.1 Periods Subsequent to Initial Measurement

Absent a change in estimate, after being initially measured at fair value, the ARO is accreted to the full obligation using the interest method over the period from initial measurement to the expected timing of the retirement.

In accordance with FAS 143, a change in estimate of an ARO occurs when there is a revision in the timing or the amount of the original estimate of undiscounted cash flows. If the revision results in a reduction to the obligation, the original discount rate is used to discount the revised cash flow estimates. If the revision results in an upward adjustment to the undiscounted cash flows, a new discount rate, reflecting current market conditions, is applied to the incremental cash flows. FAS 157 does not change these requirements.

Although FAS 157 did not significantly impact the measurement of an asset retirement obligation, there are certain questions that arise as a result of application of FAS 157:
Question 9-16: Does adoption of FAS 157 trigger remeasurement of existing asset retirement obligations?

PwC Interpretive Response
The adoption of FAS 157 does not represent a triggering event for the measurement or remeasurement of existing AROs. No specific adjustment to the ARO balances is required at the time of adoption of FAS 157; FAS 157 will be applied to new AROs and to any new layer that is added to an existing ARO balance subsequent to adoption of the Standard.

Question 9-17: What are the FAS 157 disclosure requirements for AROs?

PwC Interpretive Response
An asset retirement obligation is initially measured at fair value and is subsequently accreted through earnings. A change to the timing or amount of undiscounted cash flows expected to be paid to retire the asset after initial measurement creates a change in estimate event for the ARO. FAS 157 requires specific disclosures for recurring and nonrecurring fair value measurements.

AROs are initially recognized at fair value when a reasonable estimate of fair value can be made. The initial measurement of an ARO is subject to the measurement requirements of FAS 157. However, the disclosure requirements for nonrecurring measurements under FAS 157 only apply to "assets and liabilities that are measured at fair value on a nonrecurring basis in periods subsequent to initial recognition (e.g., impaired assets) …" Therefore, these disclosures would not apply to the initial measurement of an ARO. The disclosures required for recurring measurements at fair value are also not applicable as the original liability is not subsequently remeasured at fair value.

Subsequent to initial recognition, period-to-period changes to the asset retirement obligation are recorded to reflect the passage of time, and revisions to either the timing or the amount of the original estimate of undiscounted cash flows. Changes to the ARO due to the passage of time do not represent a remeasurement at fair value and are not subject to the requirements of FAS 157. Changes to the timing and amount of estimated cash flows are accounted for as follows:

- Downward adjustment – recorded at the original discount rate which is not a fair value measurement; and therefore, not subject to FAS 157.

- Upward adjustment – recorded at a current credit-adjusted risk free rate, however, a new "layer" is created (i.e., only the incremental cash flows are measured at the current discount rate). Paragraph A26 of FAS 143, as amended by FAS 157, states, "Any changes that result in upward revisions to the expected cash flows shall be treated as a new liability and discounted at the current rate."

As the recording of the revision for an upward adjustment represents a "new liability," we believe the upward revision is an initial measurement under FAS 143. As a result, we believe that while the concepts of FAS 157 must be used to determine the fair value of any new AROs, including "layers" associated with an existing ARO, the nonrecurring disclosures of FAS 157 are not required for AROs, as only the initial recording of an ARO is at fair value, not subsequent...
remeasurements. The disclosures required by paragraph 22 of FAS 143, however, are similar to those required by FAS 157, including a reconciliation of beginning and ending balances, and disclosure of activity during the period. In addition, a reporting entity is not precluded from providing supplemental disclosure consistent with the requirements of paragraph 33 of FAS 157 for nonrecurring measurements, to the extent it believes such disclosures will be useful to users of the financial statements.
Chapter 10:
Industry Specific Guidance
Chapter 10: Industry Specific Guidance

10.1 Investment Companies

Reporting entities within the scope of the AICPA Audit and Accounting Guide for Investment Companies (the Investment Company Guide) are required to report investments at fair value. These entities are large users of derivatives and other financial instruments that are recorded at fair value. As a result, to the extent that the concepts under FAS 157 have not been applied in practice by investment companies, the adoption of the Standard may have a significant impact. This section addresses key questions and answers on topics relevant for reporting entities within the scope of the Investment Company Guide, including investment company complexes and private equity companies.

10.1.1 Investment Company Complexes

Question 10-1: May investment company complexes adopt FAS 157 on a uniform date?

PwC Interpretive Responses

Certain investment companies may have multiple funds with different fiscal year-ends in the same investment company complex. Adopting FAS 157 on a fund-by-fund basis could result in funds within the same complex adopting the Standard in multiple reporting periods. However, FAS 157 must be adopted at the beginning of a reporting entity’s fiscal year, so a single adoption date for funds that are reporting entities with different fiscal year-ends is not an option. However, improvements in fair value measurements themselves do not need to wait for adoption prior to applying FAS 157’s provisions.

10.2 Private Equity Companies

The Investment Company Guide requires that investment companies measure private equity investments (i.e., portfolio companies) at fair value. In March 2007, the Private Equity Industry Guidelines Group released Updated US Private Equity Valuation Guidelines, which provides assistance in measuring the fair value of private equity investments and portfolio companies.

Question 10-2: How should private equity funds consider third-party transactions in measuring fair value?

PwC Interpretive Response

When a portfolio company held by a private equity fund is subject to a third-party transaction (e.g., a subsequent round of financing or minority interest sale), absent information to the contrary, there is a rebuttable presumption that such transaction represents the fair value of the portfolio company at the transaction date. Reporting entities should consider the timing of the transaction and whether the facts and circumstances related to the transaction are meaningful when measuring fair value at subsequent measurement dates. Generally, a reporting entity should not rely solely on a market transaction for the investment and should consider multiple techniques, such as a discounted cash flow analysis (Level 3 input); however, the choice of valuation techniques requires judgment.
For example, if the portfolio company recently closed a financing round that is deemed to be at arm’s length, greater weight may be given to the market transaction than to a discounted cash flow analysis. If the observed transaction is not proximate to the measurement date, the transaction information should be a Level 3 input. FAS 157 indicates that the level in the fair value hierarchy in which the fair value measurement falls should be determined based on the lowest-level input that is significant to the fair value measurement in its entirety. As the choice of valuation techniques will vary based on individual facts and circumstances, we expect that fair value measurements of portfolio companies may fall into either Level 2 or Level 3, depending on the valuation techniques employed.

**Question 10-3: How should investment companies account for transaction costs under FAS 157?**

**PwC Interpretive Response**

Transaction costs are the incremental direct costs of selling an asset or transferring a liability in the principal or most advantageous market for that asset or liability. FAS 157 explains that transaction costs are not attributes of an asset or liability but are specific to the transaction and, unless required by other GAAP, should not be included in the measurement of fair value. Transaction costs should be accounted for in accordance with the provisions of other accounting pronouncements. Entities that apply the accounting prescribed in the Investment Company Guide and initially record investments on a cost basis, should include transaction costs in the initial cost basis. These entities are required to subsequently measure investments at fair value, which results in potential unrealized losses on investments, reflecting the difference between an investment’s fair value (i.e., exit price) and its cost basis (inclusive of transaction costs).

**10.3 Insurance Companies**

The financial statements of insurance enterprises typically include significant accounts that are carried at fair value in accordance with existing accounting standards, including financial instruments (such as fixed-maturity and equity security investments) and freestanding and embedded derivatives. Certain nonfinancial instruments, such as real estate acquired in settling mortgage guaranty and title insurance claims, are also recorded at fair value. In addition, insurance enterprises may now elect the fair value option under FAS 159 for qualifying assets and liabilities, including certain insurance liabilities. As a result, the adoption of FAS 157 is expected to have a significant impact for insurance enterprises in many areas. This section provides interpretive guidance with respect to certain key implementation issues specific to the insurance industry.

**Question 10-4: How should an insurance company identify potential exit markets for insurance contracts and for embedded derivatives in such contracts?**

**PwC Interpretive Response**

Even if there is no active market in which to transfer insurance and investment contract liabilities and the embedded derivatives in such contracts, FAS 157 requires that a fair value measurement reflect the price the transferor would
pay to transfer the liability in an orderly transaction between market participants at the measurement date. Thus, an entity valuing a contract or embedded derivative component of a contract in the absence of an observable market would need to determine the hypothetical market in which the transfer would occur.

Some have suggested that reinsurance is the exit market for insurance contracts, investment contracts, and embedded derivative components of such contracts. However, while reinsurance may be a viable way to economically transfer the risks related to these contracts, in the typical indemnity reinsurance transaction the ceding entity is still primarily obligated to the insureds, and thus indemnity reinsurance is not equivalent to a complete transfer of the obligation as contemplated in FAS 157. Thus, while actual or hypothetical reinsurance transactions may offer data points/inputs into the fair value measurement, they would not necessarily be representative of an exit price. Accordingly, if reinsurance transactions (either actual or hypothetical) are used as inputs, one would need to consider how those inputs might differ from an actual transfer, including reinsurance contract terms, such as termination provisions, loss limits, potential premium adjustment provisions, remaining services provided by the cedent (such as policy administration and claims handling), and compliance (primary obligor risks, such as market conduct and reputational risks).

As an alternative to reinsurance, another direct insurer may provide a hypothetical market, possibly viewed in the context of a business acquisition. Such an approach would require consideration of the type of acquirer this would involve — that is, whether the buyer would be a strategic buyer or a financial buyer, the size of the buyer and size of the portfolio that would be purchased, the efficiencies in administrative systems of a typical market participant, and other factors.

For many, if not all, insurance and investment contracts or embedded derivative components of such instruments, because of their unique features and lack of an established active market for transfers of the obligations, significant unobservable inputs typically will be required in estimating fair value, and thus the estimates are likely to be Level 3 estimates for disclosure purposes. Such unobservable inputs will reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the specific portfolio, using the best information available, which might include the entity’s own data. The reporting entity’s own data should be adjusted if information indicating that market participants would use different assumptions is reasonably available without undue cost and effort. However, in many cases there may be no reason to believe that the reporting entity’s own assumptions are not consistent with those of a typical market participant.

**Question 10-5: How should an insurance company incorporate insurance contract acquisition costs in the fair value measurement?**

**PwC Interpretive Response**

When contracts are accounted for under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises (FAS 60)*, or FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
(FAS 97), acquisition costs meeting specified criteria are capitalized and amortized. In contrast, when measuring an entire insurance contract at fair value, acquisition costs should be expensed as incurred, because capitalization is a component of the FAS 60 and FAS 97 insurance contract models but is not a component of a fair value model. Nevertheless, the exit price of an insurance contract often implicitly includes the price the acquirer of an obligation would pay for an insurer’s acquisition efforts. To the extent a market participant would incorporate the value of acquisition efforts into the price at which it would be willing to execute the transaction, such value would need to be incorporated into the fair value of the insurance contract. Only the value that would be considered in a market transaction should be included.

If only an embedded derivative component of an insurance contract is measured at fair value, the GAAP applied to the host contract should be utilized when accounting for the acquisition costs associated with the host contract. Any acquisition costs associated with the embedded derivative that is bifurcated should be expensed as incurred. If the acquisition costs associated with an embedded derivative component are not explicitly identifiable, judgment will be needed to determine what, if any, costs should be allocated to the embedded derivative, taking into consideration whether a hypothetical market participant, purchasing the embedded derivative, would consider these costs in its price. In practice, the allocated premium associated with a bifurcated derivative that was embedded in a hybrid insurance contract is often viewed as not including a portion of the premiums charged for the hybrid contract as reimbursement for the insurer’s acquisition costs. That is, many reporting entities do not view the embedded derivative as resulting in any incremental acquisition costs, believe that their assumption is consistent with that of other market participants, and thus may not allocate any acquisition costs to the embedded feature(s) that is (are) bifurcated.

Question 10-6: How significant is consideration of nonperformance risk (including credit risk) likely to be in the measurement of fair value for an insurance or investment contract liability?

PwC Interpretive Response

FAS 157 requires that the fair value of a liability reflect the nonperformance (including credit) risk relating to that liability. In the debt market, changes in either an entity’s specific credit rating or general credit spreads will typically have a direct and immediate impact on the fair value of the instrument. However, for certain insurance and investment contracts, premium pricing can be relatively insensitive to changes in ratings that relate to an insurer’s claim paying ability or overall financial strength (at least within the upper levels of credit). For example, for retail products, consumers often do not distinguish a difference in claim paying ability above some level that is deemed acceptable. The commercial insurance and reinsurance markets may be somewhat more sensitive to credit rating changes.

The existence of state or other governmental guaranty funds and collateralization may also serve to reduce the significance of nonperformance risk in these measurements. As discussed in Question 4-9, credit risk may differ among liabilities of the same entity for a number of reasons. In addition to the items highlighted in the response to that question, insurance contract liabilities may have other features that may be considered when measuring fair
value. For example, variable annuity, variable life and certain pension contracts may be collateralized by insurance company separate account assets. Funds in a separate account are not commingled with other assets of the insurance company for investment purposes. In the U.S., certain separate account assets are legally insulated from the general account liabilities of an insurance company such that the separate account contract holder is not subject to insurer default risk to the extent of assets held in the separate account. Another unique aspect of insurance company operations is state guaranty funds, which help to pay claims of insolvent insurance companies. State laws specify the lines of insurance covered by these funds and the dollar limits payable.

In order to consider collateralization or a third-party guarantee in valuing a liability, such a feature must be an attribute of the instrument and inseparable from it. For example, with regard to state guaranty funds, it may be appropriate to consider their impact in the assessment of nonperformance risk if the guarantee would apply to the contract in the event the liability were transferred (i.e., if the guaranty fund remains obligated to provide its guaranty on the contract liability). This fact should be verified with appropriate legal or regulatory experts, as laws may vary by state and by type of insurance contract. Other restrictions may also exist, such as limitations on the amount of coverage provided by the guaranty fund for specific types of contracts. Similarly, while separate account liabilities are generally collateralized by the related separate account assets, the extent of the legal insulation provided by the separate account arrangement may vary from jurisdiction to jurisdiction.

Question 10-7: How should an insurance company consider nonperformance risk relating to separate components of a hybrid insurance contract?

PwC Interpretive Response
Determining the nonperformance risk relating to the components of an insurance contract containing an embedded derivative that is bifurcated for financial reporting purposes (e.g., a variable annuity with a guaranteed minimum accumulation benefit) requires consideration of the nature of the hybrid instrument’s contractual terms and whether payments under each of the contractual components (i.e., the host contract and the embedded derivative) have the same or different credit standings. Essentially, the individual components should be treated as separate liabilities of a single entity that may have different levels of nonperformance risk. For example, in the case of a variable annuity with a guaranteed minimum accumulation benefit, the variable annuity host liability may be fully collateralized by related separate account assets, while the bifurcated minimum guarantee is not. In such a case, the nonperformance risk of the bifurcated embedded derivative would need to be considered separately based on its specific attributes.
**Question 10-8: How should an insurance company consider guarantees related to future contract deposits?**

**PwC Interpretive Response**

For an insurance or investment contract, such as a variable annuity with a guarantee feature, an insurance company may be required to incorporate guarantees on future potential deposits permitted under the current contract (i.e., to the extent the fee is locked in and differs from a current market fee).

The guarantee, and the right to make future deposits that will be subject to the guarantee, are attributes of the existing contract. Therefore, such assumptions need to be incorporated into the valuation if a market participant would incorporate these attributes into the price at which it would be willing to execute the transaction. This may be a change from previous practice whereby such additional deposits may not have been considered under an entry price approach.

**Question 10-9: Is an insurance company required to estimate separate risk margins for each significant assumption used to measure fair value for insurance liabilities?**

**PwC Interpretive Response**

FAS 157 requires that inputs to valuation techniques include the assumptions that market participants would use in pricing the asset and liability, including assumptions about risk. This includes the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. However, FAS 157 does not require that a separate risk margin be explicitly estimated for each input into a fair value estimate.

For fair value measurements that use a present value technique, Appendix B of FAS 157 provides implementation guidance on how assumptions about risk can be factored into the present value calculation, describing three different methods that adjust the cash flows for risk. One method, the discount rate adjustment technique, uses a single set of cash flows (contractual, promised, or most likely) and a risk-adjusted discount rate to capture all the risk and uncertainty of that single set of cash flows. However, this method assumes that the release of all risks is purely time based, which will not always be the case. The other two methods are variations of the expected cash flow technique. The first uses risk-adjusted expected cash flows discounted using a risk-free rate, so that the entire risk premium is captured in the cash flows, and the second uses expected cash flows and a risk-adjusted discount rate (but different from the risk-adjusted rate used in the discount rate adjustment technique). The latter method thereby captures the risk and uncertainty through use of both expected cash flows and the discount rate. In addition, market participants might apply industry-based risk assumptions, such as risk-neutral or policyholder behavior assumptions with risk margins. If specific risk measurement methodologies are used for certain types of policies or contracts by market participants, they should be considered in the measurement of fair value under FAS 157.
Question 10-10: Does FAS 157 apply to separate account assets and liabilities of insurance companies?

PwC Interpretive Response

FAS 60 and AICPA Statement of Position 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* (SOP 03-1), require that qualifying separate account assets be valued at fair value. Therefore, FAS 157 applies to separate account assets.

SOP 03-1 requires that for separate account arrangements meeting the criteria for separate account presentation, the separate account liability should be recorded at an amount equal to the amount credited to the contract holder, which is typically determined as contract holder deposits less withdrawals, less fees and charges assessed, plus or minus the change in fair value of the corresponding separate account assets. This is not equivalent to a fair value measurement of the contract, as it does not consider the fair value associated with other components of the contract such as annuity purchase rate guarantees, minimum account guarantees, and future fees and other assessments. Thus, while separate account liabilities are recorded at an amount equal to separate account assets and while separate account assets are required to be reported at fair value, this does not necessarily result in the separate account liability or the entire contract liability being recorded at fair value. Therefore, FAS 157 does not apply to the valuation of separate account liabilities.

While FAS 157 does not directly apply to the valuation of separate account liabilities, there may be embedded derivatives associated with separate account contracts that will be recorded in the general account under FAS 133 at fair value through income. These derivatives, such as guaranteed minimum accumulation benefits and guaranteed minimum withdrawal benefits are within the scope of FAS 157.

Question 10-11: What FAS 157 disclosures are required for separate account assets and liabilities?

PwC Interpretive Response

Because FAS 157 is applicable to separate account assets, all of the disclosure requirements in paragraph 32 of FAS 157 apply. The disclosures are not required for separate account liabilities because they are not within the scope of FAS 157, as further described in Question 10-10 above. However, a reporting entity would not be precluded from providing additional disclosure regarding the linkage between the separate account asset and separate account liability valuation, including disclosures of the amounts pertaining to separate account assets and related separate account liabilities that economically offset each other. The disclosures could explain that the investment performance of separate account assets and the corresponding amounts credited to the separate account liability are offset within the same statement of operations line item netting to zero.

A reporting entity may also decide that the FAS 157 disclosures are more appropriately placed with other disclosures related to separate accounts, rather than as part of the overall FAS 157 footnote disclosure.
**Question 10-12: What are the specific FAS 157 considerations for insurance companies with respect to FAS 107 disclosures?**

**PwC Interpretive Response**

FAS 157 amends FAS 107 to incorporate the FAS 157 definition of fair value. However, FAS 157 does not change the requirement in FAS 107 that for deposit liabilities with no defined maturities, the fair value to be disclosed is the amount payable on demand at the reporting date. This requirement is stated in the context of a discussion of deposit liabilities of financial entities which notes that long-term relationships with depositors, commonly known as core deposit intangibles, are separate intangible assets, and are not financial instruments.

Consistent with the guidance in FAS 107, FAS 159 does not allow the fair value option for valuing deposit liabilities (which are withdrawable on demand) of banks, savings and loan associations, credit unions, and other similar depository institutions. Some insurance and investment contracts include features that permit the insured (or the investor) to withdraw (i.e., demand) amounts specified in the contract. We believe that insurance and investment contracts issued by insurance companies are eligible for the fair value option because the scope exception described in FAS 159 is limited to demand-deposit liabilities of specified financial institutions. Consistent with that categorization, we do not believe that investment contracts issued by insurance companies are eligible for the fair value option. As a result, such insurance and investment contracts issued by insurance companies are required to be valued for FAS 107 disclosure purposes using the guidance in FAS 157. This may be a change from previous practice, under which some insurance companies have disclosed surrender value as fair value.
Appendix A:
Definition of Key Terms
Appendix A: Definition of Key Terms

Key terms used throughout FAS 157 include the following:

Active market
An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available... (FAS 157, paragraph 24)

Blockage factor
If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market’s normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price. (FAS 157, paragraph 27)

Cost approach
The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence, and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives). (FAS 157, paragraph 18(c))

Entry price
When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). (FAS 157, paragraph 16)

Exit price
The fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). (FAS 157, paragraph 16)

Fair value
Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (FAS 157, paragraph 5)
Fair value hierarchy

To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

... the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall. (FAS 157, paragraphs 22 and 23)

Highest and best use (valuation premise)

In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different. (FAS 157, paragraph 12)

Income approach

The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula (a closed-form model) and a binomial model (a lattice model), which incorporate present value techniques; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets. (footnotes omitted) (FAS 157, paragraph 18(b))

Inputs

In this Statement, inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk, for example, the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique. Inputs may be observable or unobservable... Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs. (FAS 157, paragraph 21)

In-exchange

The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis... If the highest and best use of the asset is in-exchange, the fair value of the asset shall be measured using an in-exchange valuation premise. When
using an in-exchange valuation premise, the fair value of the asset is
determined based on the price that would be received in a current transaction
to sell the asset standalone. (FAS 157, paragraph 13(b))

In-use
The highest and best use of the asset is in-use if the asset would provide
maximum value to market participants principally through its use in
combination with other assets as a group (as installed or otherwise configured
for use)... If the highest and best use of the asset is in-use, the fair value of the
asset shall be measured using an in-use valuation premise. When using an in-
use valuation premise, the fair value of the asset is determined based on the
price that would be received in a current transaction to sell the asset assuming
that the asset would be used with other assets as a group and that those
assets would be available to market participants. (FAS 157, paragraph 13(a))

Level 1 inputs
Level 1 inputs are quoted prices (unadjusted) in active markets for identical
assets or liabilities that the reporting entity has the ability to access at the
measurement date. (FAS 157, paragraph 24)

Level 2 inputs
Level 2 inputs are inputs other than quoted prices included within Level 1 that
are observable for the asset or liability, either directly or indirectly. If the asset
or liability has a specified (contractual) term, a Level 2 input must be
observable for substantially the full term of the asset or liability. Level 2 inputs
include the following:

Quoted prices for similar assets or liabilities in active markets

Quoted prices for identical or similar assets or liabilities in markets that are not
active, that is, markets in which there are few transactions for the asset or
liability, the prices are not current, or price quotations vary substantially either
over time or among market makers (for example, some brokered markets), or
in which little information is released publicly (for example, a principal-to-
principal market)

Inputs other than quoted prices that are observable for the asset or liability (for
example, interest rates and yield curves observable at commonly quoted
intervals, volatilities, prepayment speeds, loss severities, credit risks, and
default rates)

Inputs that are derived principally from or corroborated by observable market
data by correlation or other means (market-corroborated inputs).

(FAS 157, paragraph 28)

Level 3 inputs
Level 3 inputs are unobservable inputs for the asset or liability. Unobservable
inputs shall be used to measure fair value to the extent that observable inputs
are not available, thereby allowing for situations in which there is little, if any,
market activity for the asset or liability at the measurement date …
unobservable inputs shall reflect the reporting entity’s own assumptions about
the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity’s own data… the reporting entity’s own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions. (FAS 157, paragraph 30)

Market approach
The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might lie in ranges with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement (qualitative and quantitative). Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities. (FAS 157, paragraph 18(a))

Market participant
Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

Independent of the reporting entity; that is, they are not related parties

Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary

Able to transact for the asset or liability

Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

(footnote omitted) (FAS 157, paragraph 10)

Most advantageous market
The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s). … the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. (FAS 157, paragraph 8)
Nonperformance risk
Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred… Nonperformance risk includes but may not be limited to the reporting entity’s own credit risk. (FAS 157, paragraph 15)

Observable inputs
Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. (FAS 157, paragraph 21(a))

Orderly transaction
An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). (FAS 157, paragraph 7)

Principal market
The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume or level of activity for the asset or liability. … the principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market (whether the price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date. (FAS 157, paragraph 8)

Transaction costs
Transaction costs represent the incremental direct costs to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. Transaction costs are not an attribute of the asset or liability; rather, they are specific to the transaction and will differ depending on how the reporting entity transacts. However, transaction costs do not include the costs that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. (footnotes omitted) (FAS 157, paragraph 9)

Transportation costs
If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market. (FAS 157, paragraph 9)
Unit of account
A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating unit) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business). Whether the asset or liability is a standalone asset or liability or a group of assets and/or liabilities depends on its unit of account. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements. The unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements, except as provided in paragraph 27. (footnote omitted) (FAS 157, paragraph 6)

Unobservable inputs
Unobservable inputs are inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. (FAS 157, paragraph 21(b))

Valuation technique
Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value. (FAS 157, paragraph 18)
Appendix B: APB and FASB Pronouncements Amended by FAS 157
### Appendix B: APB and FASB Pronouncements Amended by FAS 157\(^1\)

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<td>1. APB Opinion No. 21, <em>Interest on Receivables and Payables</em> Refer to paragraph E1 of FAS 157.</td>
<td>APB 21 establishes a present value technique for measuring receivables and payables. FAS 157 updates APB 21’s definition of present value.</td>
<td>No.</td>
<td>In paragraph C19 of FAS 157, the Board affirmed that the measurement for receivables and payables, determined using a present value technique in APB 21, is a fair value measurement. Paragraph C20 of FAS 157 states, “…the guidance for using present value techniques to measure fair value in this Statement applies for the measurements required under Opinion 21.” Accordingly, while APB 21 retains its methodology of imputing an interest rate when determining the appropriate discount rate in a present value technique, the concepts of FAS 157 should be applied. However, the methodology as outlined in Appendix A of APB 21 is not substantively different, except that the discount rate previously established under APB 21 would normally be at least equal to the rate at which the debtor could obtain similar financing from other sources, meaning it could be that rate or higher. Under FAS 157, that appropriate rate will be determined based on market participant assumptions. Refer to amended paragraph 13 of APB 21.</td>
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\(^1\) Appendix based on FAS 157, Appendix E, "Amendments to APB and FASB Pronouncements." See also FAS 157, Appendix D, for a complete list of APB and FASB pronouncements that refer to fair value, including indications of which pronouncements are amended by FAS 157.
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| 2. APB Opinion No. 28, *Interim Financial Reporting* (APB 28) | FAS 157 amends APB 28 by adding a new paragraph (30(l)), which requires interim disclosures of information about the use of fair value (recurring and nonrecurring measurements) pursuant to paragraphs 32 and 33 of FAS 157. | No. | The disclosure requirements of FAS 157 increase the volume of disclosure in both interim and annual financial statements. **Related Questions**

See overall discussion of disclosures in Chapter 5: Disclosures. In addition, see discussion of specific disclosure matters as follows:

- Question 8-7: What are the FAS 157 disclosure requirements for pension and OPEB plans?
- Question 9-12: Which FAS 157 disclosures are required for tests of impairment of goodwill and indefinite-lived assets? What disclosures are required if an impairment is recognized?
- Question 9-15: What are the FAS 157 disclosure requirements for an impairment of a long-lived asset to be held and used?
- Section 9.3.2.1, “Long-Lived Assets Held for Sale - FAS 157 Disclosure Requirements”
- Question 9-17: What are the FAS 157 disclosure requirements for AROs?
- Question 10-11: What FAS 157 disclosures are required for separate account assets and liabilities?
- Question 10-12: What are the specific FAS 157 considerations for insurance companies with respect to FAS 107 disclosures?
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<td>3. APB Opinion No. 29, Accounting for Nonmonetary Transactions (APB 29) and FASB Statement No. 153, Exchanges of Nonmonetary Assets</td>
<td>APB 29 and FAS 153, (an amendment of APB 29), require that nonmonetary transactions be accounted for at fair value, based on the fair value of the asset being surrendered. FAS 157 amends APB 29's fair value definitions to be consistent with FAS 157. The prior definition referred to “estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence.”</td>
<td>APB 29, as amended by FAS 153, requires that a nonmonetary exchange be measured based on the recorded amount of the asset relinquished (instead of fair value) if (a) the fair value of either the asset received or relinquished is not reasonably determinable; (b) the exchange is for the purpose of facilitating a sale to customers (other than the parties to the exchange); or (c) the exchange does not have commercial substance.</td>
<td>While the prior definition of fair value in APB 29 used some of the same concepts as in FAS 157, a reporting entity will now be required to evaluate the following when measuring the fair value of nonmonetary exchanges: • Its principal and most advantageous markets when considering sales of the same or similar assets; and • The valuation premise – i.e., would the asset being surrendered have a highest and best use when sold in-use or in-exchange? The incorporation of these concepts may result in changes in practice. FAS 157 retains the concept under APB 29, that if one of the parties could have elected to receive cash instead of the nonmonetary asset, that cash amount may be evidence of the fair value of the nonmonetary transaction to be recorded.</td>
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<td>4. FASB Statement No. 13, Accounting for Leases Refer to paragraph E4 of FAS 157.</td>
<td>On November 28, 2007, the FASB issued proposed FSP FAS 157-a, Application of FASB Statement No. 157 to FASB Statement No. 13 and Its Related Interpretive Accounting Pronouncements That Address Leasing Transactions. The FSP as proposed will exclude leases from the scope of FAS 157.</td>
<td>Not applicable, provided the proposed FSP is issued as currently drafted.</td>
<td>Not applicable, provided the proposed FSP is issued as currently drafted. See further discussion in Section 2.1.1.3, “Lease Accounting.”</td>
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<td>5. FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings (FAS 15) Refer to paragraph E5 of FAS 157.</td>
<td>Fair value is the measure used to determine the gain or loss when a debtor transfers assets in full settlement of a troubled payable. The carrying amount of the payable is compared to the fair value of the assets transferred. The prior concept under FAS 15 was defined by what could be received in a sale between willing buyers other than in a forced or liquidation sale. Prior to FAS 157, FAS 15 referenced market value when an active market exists; otherwise a similar asset’s market or expected cash flows could be an input when determining fair value.</td>
<td>No.</td>
<td>Principal and most advantageous markets and the valuation premise will need to be considered when determining the fair value of the assets to be transferred. Applying these concepts may result in differences in gains and losses recognized, as compared to prior practices.</td>
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<td>6. FASB Statement No. 19, <em>Financial Accounting and Reporting by Oil and Gas Producing Companies</em> Refer to paragraph E6 of FAS 157.</td>
<td>The concept of present value is used in the accounting for the purchase of a proved property subject to retained production payments by the purchaser (in the case of a production payment that is not based on volume). The purchaser must record the present value of the retained production payments as a payable. FAS 157 removes the reference to APB 21’s prior definition of present value.</td>
<td>No.</td>
<td>A non-volumetric production payment payable is similar to a loan which, prior to adoption of FAS 157, would be reported using a present value approach. Valuation subsequent to adoption of FAS 157 will require a reporting entity to incorporate market participant inputs, including consideration of nonperformance risk (including credit risk) into present value models and apply all other provisions of FAS 157. Arrangements involving non-volumetric production payments have been rare and therefore the amendment by FAS 157 may not have a significant impact.</td>
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<td>7. FASB Statement No. 35, <em>Accounting and Reporting by Defined Benefit Pension Plans</em>; FASB Statement No. 87, <em>Employers’ Accounting for Pensions</em>; and FASB Statement No. 106, <em>Employers’ Accounting for Postretirement Benefits Other Than Pensions</em></td>
<td>These standards require that plan assets be recorded at fair value. The prior concept under these standards was defined by what could be received in a sale between willing buyers other than in a forced or liquidation sale. These standards referenced market value when an active market exists; otherwise similar assets’ expected cash flows could provide assistance in determining fair value. The disclosure requirements of FAS 157 are applicable to financial statements of the plan but not to the financial statements of plan sponsors. On November 14, 2007, the Board approved a project to prepare an FSP to address disclosures regarding plan assets through FAS 132(R). The final FSP, if issued, may require certain disclosures similar to those in FAS 157 for pension and postemployment (OPEB) benefit plan assets. However, until a final FSP is approved and issued, fair value disclosures by employers for pension and OPEB plan assets are not required.</td>
<td>FAS 87 provides an exemption to the requirement to measure fair value if it is not reasonably determinable for the recognition of participation rights associated with a participating annuity contract. FAS 106 provides the same exemption for participating insurance contracts. Paragraph 62 of FAS 87 provides a practicability exception for insurance contracts with determinable cash surrender values or conversion values, in which case those values are presumed to be fair value.</td>
<td>Employers may need to work more closely with trustees in order to obtain the information necessary to support the required FAS 157 disclosures for plan assets by the plan. The impact will be most notable for investments classified in the lower levels of the fair value hierarchy, such as real estate and alternative investments. <strong>Related Questions</strong> See Section 8.6, “Pensions and Postemployment Benefit Obligations.”</td>
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| 8. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* Refer to paragraph E8 of FAS 157. | FAS 60 requires real estate acquired in settling mortgage guaranty and title insurance claims to be reported at fair value. Prior to FAS 157, FAS 60’s fair value concept was defined by what could be received in a sale between a willing buyer and a willing seller other than in a forced or liquidation sale. FAS 60 made reference to market value when an active market exists; otherwise discounted expected cash flows could be used when estimating fair value. | No. | Under FAS 157, the exit market and the valuation premise will now be considered when determining fair value. Application of these concepts may result in differences in the reported fair value of acquired real estate by insurance enterprises.  

**Related Questions**  
See Section 10.3, “Insurance Companies,” for further discussion. |
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<td>9. FASB Statement No. 63, <em>Financial Reporting by Broadcasters</em> (FAS 63) Refer to paragraph E9 of FAS 157.</td>
<td>A licensee shall report the asset and liability for a broadcast license agreement either at the fair value of the liability or at the gross amount of the liability as an accounting policy election. Under FAS 63, the fair value of the liability, if used, was defined as the present value approach in accordance with APB 21. FAS 157 retains FAS 63's reference to a present value technique as an acceptable method of estimating fair value. Barter transactions on unsold advertising time are also reported at the estimated fair value of the product or service received. FAS 63 required that entities use the estimated net realizable value approach in APB 29. That approach has been eliminated by FAS 157.</td>
<td>No.</td>
<td>The amount of the broadcast license asset and liability is based upon the estimate of the fair value of the liability. Therefore, to the extent that an entity’s accounting policy election is fair value (and not the gross amount of the liability), it must now follow the fair value concepts in FAS 157 for liabilities. We understand that an accounting policy election based on fair value is rare in practice. However, in those cases, the amendment may result in a change in practice given that reporting entities must consider the amount that the liability could be transferred for, which incorporates nonperformance risk and other market participant assumptions. Additionally, entities will now be required to incorporate the FAS 157 exit price concepts when determining the fair value of a product or service received in a barter transaction.</td>
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<td>10. FASB Statement No. 65, <em>Accounting for Certain Mortgage Banking Activities</em> Refer to paragraph E10 of FAS 157.</td>
<td>FAS 65 requires that mortgage loans held for sale be recorded at the lower of cost or fair value (prior to FAS 157, the terminology used by FAS 65 was “lower of cost or market value”). Further, mortgage loans transferred to long-term investment classifications must be transferred at the lower of cost or fair value at the transfer date. FAS 157 amended FAS 65 by replacing the term “market value” throughout FAS 65 with “fair value.”</td>
<td>No.</td>
<td>While the terminology pre- and post- FAS 157 is different, we understand that estimates of “market value” have been performed using concepts similar to those in FAS 157. Therefore, practice may not change significantly as a result of FAS 157. <strong>Related Questions</strong> See Section 8.1.1, “Mortgage Loans Held for Sale,” for further discussion.</td>
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<td>11. FASB Statement No. 67, <em>Accounting for Costs and Initial Rental Operations of Real Estate Projects</em> (FAS 67) Refer to paragraph E11 of FAS 157.</td>
<td>FAS 67 requires that capitalizable costs of amenities (as defined by FAS 67) that are to be sold separately or retained by the developer in a real estate project, in excess of their fair value, be allocated to the amenities as common costs. Further, costs of amenities are to be allocated among land parcels. FAS 67, as amended, describes what the fair value of a land parcel is affected by, using the concepts in FAS 157. The prior definition of fair value within FAS 67 is removed by FAS 157.</td>
<td>No.</td>
<td>Amenities (e.g., clubhouses and community pools) are usually subject to restrictions on sale that may be an attribute of the asset and require consideration in the measurement of fair value. The methodology of estimating the fair value of those amenities under FAS 157 is similar to the methodology applied in FAS 67 prior to its amendment. Therefore, practice may not change as a result of FAS 157.</td>
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| 12. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* Refer to paragraph E14 of FAS 157. | FAS 107 requires certain disclosures of the fair value of financial instruments, both recognized and not recognized in the statement of financial position. FAS 157 provides the definition of fair value to be used for balances subject to these disclosure requirements. | FAS 107 provides an exemption from the requirement to disclose fair value if it is not practicable. | Fair value of financial assets and liabilities may be significantly impacted by the change in definition of fair value to reflect an exit price. A common practice of reporting entities is to disclose that the carrying values of accounts receivable and accounts payable approximate fair value, due to short maturities. While the short-term nature of these accounts may result in a carrying value approximating fair value, reporting entities will need to consider exit markets for both accounts receivable and accounts payable. In addition, the transfer concept will need to be considered instead of the settlement concept for accounts payable, taking into account credit and nonperformance risk. Related Questions  
• Question 5-2: Are fair value measurements required by FAS 107 subject to the FAS 157 disclosure requirements?  
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<td>13. FASB Statement No. 115, <em>Accounting for Certain Investments in Debt and Equity Securities</em> and FASB Statement No. 124, <em>Accounting for Certain Investments Held by Not-for-Profit Organizations</em> Refer to paragraphs E15 and E17 of FAS 157.</td>
<td>FAS 115 requires that all debt and equity securities classified as “trading” or “available-for-sale” be recorded at fair value. Under FAS 124, all investments in equity and debt securities are to be reported at fair value. For equity securities under both FAS 115 and FAS 124, only those with readily determinable fair values are within their scope, provided they are not required to be accounted for in accordance with other GAAP (e.g., equity method under APB 18). FAS 157 does not change the scope requirements of FAS 115 or FAS 124 nor does it change the definition of “readily determinable fair value.” The amendments to FAS 115 and FAS 124 clarify that “restricted stock” that otherwise meets the definition of an equity security that has a readily determinable fair value is within the scope of these two standards, if the restriction terminates within one year of the acquisition date.</td>
<td>No.</td>
<td>When measuring the fair value of restricted stock and the restriction is an attribute of the security, (i.e., restriction transfers with the security) that fair value measurement should be based upon an identical unrestricted security, adjusted for the effect of the restriction. That is, the effect of the restriction should only be considered if it would transfer to the market participant upon the sale. If the restriction is specific to the entity that owns the security, the restriction should not be considered in the valuation. There are a number of other concepts and implementation issues to consider, as further described in the following questions of this guide: <strong>Related Questions</strong> See Section 4.5, “Fair Value Hierarchy,” and Section 8.1, “Investments and Other Financial Instruments,” for further discussion.</td>
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<td>14. FASB Statement No. 116, <em>Accounting for Contributions Received and Contributions Made</em></td>
<td>FAS 116 requires entities to record contributions received and contributions made at fair value. While FAS 116 is not restricted to not-for-profit entities, it is most relevant to those organizations. FAS 157 amends FAS 116 by removing the references as to how to determine fair value.</td>
<td>FAS 116 provides an exemption to the requirement to measure fair value of contributions when fair value cannot be measured with sufficient reliability. (Also applies to the AICPA Audit and Accounting Guide, <em>Not-for-Profit Organizations</em>).</td>
<td>Since contributions are initially measured at fair value, promises to give, split interest agreements, gifts-in-kind, and beneficial interests in trusts held by third parties will all require measurement by application of the FAS 157 framework. Chapter 5 of the AICPA Audit and Accounting Guide <em>Not-for-Profit Organizations</em>, provides additional guidance. The effect of a restriction on a donated asset should only be considered if it would transfer to a market participant upon its sale. If the restriction is specific to the beneficiary receiving the contribution, the restriction should not be considered in the valuation.</td>
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<td>15. FASB Statement No. 133, <em>Accounting for Derivative Instruments and Hedging Activities</em>, as amended</td>
<td>Derivative instruments as defined by FAS 133 are required to be recorded at fair value. FAS 157 amended FAS 133 by eliminating the definition of fair value in FAS 133. FAS 157 also removed the guidance associated with Day One gains for hybrid instruments for which the fair value option is elected under FAS 155.</td>
<td>No.</td>
<td>The impact of FAS 157 on derivative assets and liabilities may be significant for contracts that have historically been valued based on an entry price. There are a number of concepts and implementation issues to consider in the valuation of derivatives, as further described in the following questions of this guide: <strong>Related Questions</strong> See Section 4.5, “Fair Value Hierarchy,” and Section 8.3, “Derivative Assets and Derivative Liabilities,” for further discussion.</td>
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16. FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others* (FAS 136)

Refer to paragraph E19 of FAS 157.

Under FAS 136, a beneficiary of a donated asset (i.e., specified cash flows from a charitable trust or other pool of assets) is required to recognize the asset at fair value. FAS 157 amends FAS 136 by eliminating the requirement to use a present value technique as previously allowed by FAS 136.

No.

Reported entities commonly employ an income approach in accordance with FAS 136. Beneficial interests will need to be evaluated to ascertain that an income approach is the most appropriate valuation technique. Depending on the nature of the assets, a market approach may be more appropriate.

The effect of a restriction on a donated asset should only be considered if it would transfer to a market participant upon its sale. If the restriction is specific to the beneficiary, the restriction should not be considered in the valuation.
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<td>17. FASB Statement No. 140, <em>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities</em> and FASB Statement No. 156, <em>Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140</em></td>
<td>Under FAS 140, (as modified by FAS 156), assets obtained and liabilities incurred by transferors as part of a transfer of financial assets are initially measured at fair value. These may include servicing assets and servicing liabilities, written and purchased put and call options, forward commitments, and swaps. FAS 140 also requires that other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer. FAS 157 amended FAS 140 to incorporate the FAS 157 definition of fair value, and removed references to CON 7. FAS 157 did not amend FAS 140’s accounting option for subsequent measurement of servicing assets and liabilities at either amortized cost or fair value. If the fair value method is elected, reporting entities must apply the FAS 157 fair value measurement concepts.</td>
<td>FAS 140 provides the ability to use a transaction price (entry price) to measure financial assets and liabilities. FAS 140 also provides an exemption to the requirement to measure fair value if it is not practicable to do so for financial assets obtained and financial liabilities incurred in a sale. The use of the practicability exception is understood to be rare.</td>
<td>It is not expected that the valuation of assets within the scope of FAS 140 will be significantly different under FAS 157. The fair value concepts in FAS 140 were similar to those in FAS 157. For example, FAS 140 required market participant assumptions as inputs for estimating fair value. Prior to FAS 157, FAS 140 provided the option of using the “settlement approach” when estimating the fair value of a liability incurred. This option was eliminated by FAS 157 which now requires use of the “transfer approach” when estimating the fair value of liabilities.</td>
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<td>18. FASB Statement No. 141, <em>Business Combinations</em> Refer to paragraph E21 of FAS 157.</td>
<td>FAS 141 generally requires that the cost of a business acquired, (which represents a combination of assets and liabilities), should be allocated to the assets and liabilities acquired based on their fair values. FAS 157 amended FAS 141 to incorporate the FAS 157 definition of fair value.</td>
<td>The use of specified measurement methods referred to in paragraph 37 of FAS 141 are considered practicability exceptions for purposes of FAS 157. FAS 141(R) eliminates most of the practicability exceptions to measuring fair value.</td>
<td>There are a number of concepts and implementation issues to consider in business combinations, as further described Section 9.1, “Business Combinations.”</td>
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<td>19. FASB Statement No. 142, <em>Goodwill and Other Intangible Assets</em> Refer to paragraph E22 of FAS 157.</td>
<td>Fair value is used when testing goodwill and indefinite-lived intangible assets for impairment under FAS 142. A CON 7 present value technique has been the common approach to estimating fair value under FAS 142. FAS 157 amended FAS 142 by removing the reference to CON 7.</td>
<td>No.</td>
<td>There are a number of concepts and implementation issues to consider in goodwill and intangibles impairment testing and reporting. We expect the use of present value approaches to valuation of businesses to remain a common measurement technique, however other approaches will also need to be considered.</td>
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<td>20. FASB Statement No. 143, <em>Accounting for Asset Retirement Obligations</em> and FASB Interpretation No. 47, <em>Accounting for Conditional Asset Retirement Obligations</em></td>
<td>Asset retirement obligations represent liabilities that are recognized on the balance sheet at fair value in accordance with FAS 143. FAS 157 amends FAS 143 by removing the reference to CON 7 and indicating that an expected present value technique will usually be the only appropriate way to estimate the fair value of an asset retirement obligation. Entities are required to discount cash flows using a credit adjusted risk free rate (unchanged from FAS 143’s previous requirement).</td>
<td>When fair value is not reasonably determinable for asset retirement obligations, the liability is not required to be recognized. If this exemption is utilized, a liability must be recognized when a reasonable estimate of fair value can be made.</td>
<td>FAS 143 encouraged but did not require consideration of market participant assumptions, particularly if obtaining that market participant information would cause undue cost and effort. Therefore, the expected present value technique using FAS 157 may render different results at the time of original recording of a new ARO or when a new layer is added to an existing ARO. <strong>Related Questions</strong> See Section 9.4, “Asset Retirement Obligations,” for further discussion.</td>
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<td>21. FASB Statement No. 144, <em>Accounting for the Impairment or Disposal of Long-Lived Assets</em></td>
<td>FAS 144 requires an impaired long-lived asset to be held and used to be measured at its fair value. It also requires that long-lived assets held for sale be measured at fair value less costs to sell. FAS 157 amends FAS 144 by removing the reference to CON 7 and indicating that an expected present value technique will often be the appropriate technique to estimate fair value, when the long-lived assets have uncertainties both in timing and amount.</td>
<td>No.</td>
<td>FAS 144 encouraged but did not require consideration of market participant assumptions, particularly if obtaining that market participant information would cause undue cost and effort. Therefore, the expected present value technique using FAS 157 may render different results. <strong>Related Questions</strong> See Section 9.3, “Long-Lived Assets,” for further discussion.</td>
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<td>22. FASB Statement No. 146, <em>Accounting for Costs Associated with Exit or Disposal Activities</em> Refer to paragraph E25 of FAS 157.</td>
<td>FAS 146 requires that liabilities for costs associated with exit or disposal activities be initially recognized at fair value when incurred. FAS 157 amends FAS 146 by removing the reference to CON 7 and indicating that an expected present value technique will generally be the appropriate technique to estimate fair value, when the liability has uncertainties in both timing and amount.</td>
<td>FAS 146 provides an exemption to the requirement to measure restructuring obligations at fair value if they are not reasonably determinable. Use of the exemption is expected to be rare, and if used, an estimate of fair value would be required as soon as practicable.</td>
<td>FAS 146 encouraged but did not require consideration of market participant assumptions, particularly if obtaining that market participant information would cause undue cost and effort. Therefore, the expected present value technique using FAS 157 may render different results upon the initial recognition of new FAS 146 liabilities.</td>
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<td>23. FASB Statement No. 150, <em>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</em> (FAS 150) Refer to paragraph E26 of FAS 157.</td>
<td>FAS 150 requires certain financial instruments classified as liabilities to be recognized initially and subsequently at fair value. FAS 150’s fair value concept was defined by what could be received in a sale between willing buyers other than in a forced or liquidation sale. That definition was eliminated by FAS 157.</td>
<td>No.</td>
<td>Certain financial instruments classified as liabilities pursuant to FAS 150 and recorded at fair value may fall under Level 3 of the fair value hierarchy and therefore require a reconciliation of period beginning and ending balances consistent with paragraph 32(c) of FAS 157 (e.g., warrants of a private company for which there is no market data).</td>
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<td>24. FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</td>
<td>FIN 45 requires that liabilities for obligations associated with guarantees be recognized at fair value, when those guarantees are within its scope. FAS 157 amends the interpretation by removing the reference to CON 7. Fair value measurements should include valuation techniques appropriate in the circumstances.</td>
<td>FIN 45 requires the use of a transaction price (entry price) to measure fair value at initial recognition. The practicability expedient applies to guarantees issued separately in an arms-length transaction and as part of a transaction with multiple elements.</td>
<td>None noted.</td>
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### Other Abbreviations

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<th>AICPA</th>
<th>American Institute of Certified Public Accountants</th>
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<td>ARB</td>
<td>Accounting Research Bulletin</td>
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<td>APB</td>
<td>Accounting Principles Board</td>
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<td>CAQ</td>
<td>Center for Audit Quality</td>
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<td>CBOT</td>
<td>Chicago Board of Trade</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<td>NYMEX</td>
<td>New York Mercantile Exchange</td>
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<td>NYSE</td>
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<td>SAB</td>
<td>Staff Accounting Bulletin</td>
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<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<td>U.S.</td>
<td>United States</td>
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### Other Terms

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<th>ARO</th>
<th>Asset retirement obligation</th>
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<td>FVO</td>
<td>Fair value option</td>
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<td>GAAP</td>
<td>Generally accepted accounting principles</td>
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<td>HFS</td>
<td>Held for sale</td>
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<td>Term</td>
<td>Description</td>
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<td>LOCOM</td>
<td>Lower of cost or market</td>
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<td>OPEB</td>
<td>Other post-employment benefit</td>
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<tr>
<td>VSOE</td>
<td>Vendor-specific objective evidence</td>
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Appendix E:  
Mapping of Questions and PwC Interpretive Responses from DataLine 2007-12
Appendix E: Mapping of Questions and PwC Interpretive Responses from DataLine 2007-12

The following table may be used to cross-reference the questions and interpretive responses from DataLine 2007-12 to this guide:

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The question titles and other references listed above represent the descriptions included within this guide. The cross-referenced sections and questions address the same topic addressed in the original DataLine 2007-12 questions; however, this guide incorporates updated questions and information to reflect the most recent guidance.
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About PricewaterhouseCoopers

PricewaterhouseCoopers (www.pwc.com), which ranks among the world’s leading employers of highly skilled, professional people, helps its clients build value, manage risk, and improve their performance.

Drawing on the talents of more than 146,000 people in 150 countries, PricewaterhouseCoopers provides a full range of business advisory services to leading global, national, and local companies, as well as to public institutions. These services include advice on audit, accounting, and tax matters; consultation on human resource issues; transaction support; business recovery; project finance; litigation support; and legal services (where permitted) through a global network of affiliated law firms.

How PwC Can Help

FAS 157 represents a fair value framework that is applicable to a wide array of reporting entities. FAS 157 is a principles-based standard that introduces a fair value framework that bases the measurement of fair value on an exit price concept, taking into account the assumptions of market participants and favoring fair value measurements that prioritize inputs that are observable in active markets. The model replaces or amends all existing fair value measurement definitions, methodologies and many disclosure requirements. Additionally, the introduction of the fair value option under FAS 155, FAS 156 and FAS 159 represents the beginning of providing reporting entities the option to report certain assets and liabilities at fair value, and incorporates the requirements of FAS 157.

Our fair value consultants and Assurance professionals frequently advise companies regarding fair value measurements and related matters, including:

- The changes to measuring fair value as a result of FAS 157 and how to implement those changes;
- Valuation methodologies;
- Disclosure requirements of FAS 157; and
- When the fair value option can be applied.

Our professionals bring value to businesses by understanding and resolving their complex business issues. There are and will be many such issues related to the implementation of FAS 157 and the fair value option.

If you have any questions or comments, please contact your PricewaterhouseCoopers partner.
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Shyam Patkar
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